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FLOATING EXCHANGE RATES' IMPACT ON INTERNATIONAL TRADING

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

APRIL 23 AND 24, 1985

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FLOATING EXCHANGE RATES' IMPACT ON INTERNATIONAL TRADING

TUESDAY, APRIL 23, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Heinz, Wallop, Grassley, Long, Bentsen, Moynihan, Baucus, and Bradley.

[The press release announcing the hearing, Senator Packwood's, Senator Heinz', and Senator Grassley's prepared statements follow:]

[Press release No. 85–019, Friday, Apr. 5, 1985]

COMMITTEE ON FINANCE SCHEDULES TWO HEARINGS ON FLOATING EXCHANGE RATES' IMPACT ON INTERNATIONAL TRADING

The Senate Committee on Finance will conduct two days of hearings to examine the viability of the international trading system in an era of floating exchange rates, Committee Chairman Bob Packwood (R-Oregon), announced today.

Senator Packwood said his Committee would conduct the hearings in three sessions over the two days—Tuesday, April 23, and Wednesday, April 24, 1985.

The Tuesday, April 23, hearings are scheduled from 9:30 a.m. to noon and again 2:30 p.m. to 4:30 p.m.

The Wednesday, April 24, hearing is scheduled 9:30 a.m. to noon.

All three sessions of the hearings are to be in Room SD-215 of the Dirksen Senate Office Building.

"The size of accumulated and projected U.S. trade deficits, and the current account deficits, are unacceptable and reflect a breakdown in the international trading system," Chairman Packwood said.

"To lay the blame for this situation on the exchange rate for the dollar is merely to beg the question of why our currency has appreciated, in spite of vast leaps in the size of the U.S. current account deficit," he said.

"Those who believed that a floating exchange rate system would operate to restore equilibrium in our international payments should re-examine their thesis in light of modern movements of capital which overwhelm the effects of surpluses and deficits in the trade account," the Committee on Finance leader said.

He said the Committee wants to examine the fundamental question of whether an open market for dollars, free of government intervention to moderate the movements in exchange rates, is compatible with free and open markets for traded goods.

Packwood said the Committee also wants to determine if assumptions reflected in the international trading system are valid under the modern exchange rate system.

"The Committee will receive testimony on the broadest possible range of options to deal with this situation," Packwood said.

STATEMENT OF SENATOR PACKWOOD

These hearings come at a time when the United States is accumulating trade and current account deficits of unprecedented proportions. We all recognize that Federal Budget deficits bear some of the blame for this imbalance. But these huge trade deficits are also a reflection of a floating exchange rate system that has behaved in ways that were not foreseen in 1973, when the Bretton Woods system of fixed exchange rates was abandoned.

We are living with an exchange rate system in which the dollar has appreciated over 50 percent in five years against the other major currencies, and has fluctuated by as much as ten percent within a two month period. These exchange rates now respond overnight to massive capital movements which dwarf all expectations of a decade ago.

Ironically, exchange rate volatility and speculative capital movements were two of the evils which the architects of Bretton Woods sought to control through fixed exchange rates. These "Founding Fathers" of the international monetary system recognized that if they didn't manage money, at least in some degree, they might be forced to manage trade.

Forty years later, we appear to be confronted by the same dilemma. The current account imbalance and exchange rate volatility must be seen as just as much a threat to the free trading system today as they were understood to be at the end of World War II.

The hearings today are an opportunity to better understand the role of floating exchange rates in the trading system. This should assist us in judging whether the monetary system needs reforming in light of its trade consequences. Forming this judgment is no mere academic exercise. For within the next few years, this committee will be asked to authorize a new round of multilateral negotiations. Such negotiations could be the context for reform, or at least adjustment, of the international monetary system.

OPENING STATEMENT OF SENATOR JOHN HEINZ

I welcome these hearings on the trade deficit and exchange rates. They are timely, and they are relevant. Our trade deficit reached a record $123 billion last year at the same time the dollar has appreciated over 50 percent against a basket of foreign currencies.

That the consequences of the status quo are disastrous is beyond debate. My Subcommittee on International Finance and Monetary Policy has held hearings on this subject virtually every year since 1981. Last year, witnesses as diverse as Paul Volcker, Martin Feldstein, and Fred Bergsten agreed that the overvaluation of the dollar was causing severe economic dislocations and indeed agreed that this overvaluation was putting the equivalent of a tax on our exports while providing a subsidy for imported goods. All agreed the dollar's strength was more reflective of worldwide capital flows than trade flows and that this situation could not continue for long without setting in motion what can only be characterized as the deindustrialization of America. Unfortunately, with the exception of Dr. Bergsten, no one has specific policy recommendations for fixing the current exchange rate system in order to make it more reflective of international trading realities. We are planning further hearings on this subject this spring.

The Administration's policy on the dollar until recently can best be described as one of benign neglect. What is worse, that policy has been pursued with considerable fanfare and pride. I recall at my Subcommittee's hearing in 1981, then Assistant Secretary of the Treasury Marc Leland announced unequivocally that the Administration's policy was not to intervene to influence the dollar's value. In my judgment that was the wrong policy. But what was worse was to announce it publicly, thereby removing from the market the cautionary impact of uncertainty.

We have witnessed the fruits of that neglect over the past four years. Had we pursued a more ambiguous approach designed to wage a degree of psychological warfare on the exchange markets, I suspect the result would have been a more modest appreciation of the dollar.

At this point, however, it may be too late for that option, and more drastic proposals will need to be considered. One of them is the general import surcharge. Another is broader systemic reform which would mean an end to freely floating exchange rates. Like the other members of the Committee, I don't particularly welcome measures like these, but I expect many of our witnesses today and tomorrow to warn us that failure to act now will leave no choice but to take more serious action later.

There are some recent signs, most notably from Treasury Secretary Baker, that concern about the dollar has begun to penetrate the higher levels of the Administration, and there seems to be a new willingness to take the problem seriously and discuss it openly. Perhaps these hearings will stimulate some new thinking there as well.

The alternative, as I have mentioned, is literally the deindustrialization of America—the shipment of our factories, our production, and our jobs overseas. Already, major companies in this country are announcing plans to close down American facilities and build new ones in Asia. That kind of action is irreversible once taken. The tragedy of the last four years is that we have brought it upon ourselves. I hope that these hearings, added to those I have held in the past, will alert both Congress and the Administration to the dangers of benign neglect and will lead to a more aggressive policy.

STATEMENT OF SENATOR CHARLES E. GRASSLEY

Mr. Chairman, the current foreign trade situation is a matter of great personal concern to me. I am particularly grateful to you for holding this hearing on the role of floating exchange rates in the international trading system, for as we all have heard more than once, the value of the U.S. dollar is said to have a direct impact on our inability to export American goods.

The world is truly an international trading community, with countries relying upon one another for markets and products. However, massive trade surpluses and deficits, such as the United States now faces, seem to jeopardize the system which benefits so many.

Balancing the Federal Government's budget by reducing or limiting spending remains one of my top legislative priorities. Federal spending must be restrained if we are to bring interest rates under control and continue with the progress we have made in lowering the rate of inflation.

Although we have made gains in reducing inflation and short-term interest rates, long-term rates remain much too high. Much of this problem is because of the unpredictable nature of monetary policy at the Federal Reserve. Money growth has been erratic in recent years, and so lenders of money are asking for a high-risk premium as the price for loans.

Not only must the Fed moderate its monetary policy, but Congress must do its part to bring interest rates under control. Long-term interest rates simply cannot drop as long as Congress shows no commitment to reduce Government spending. In borrowing money to finance the debt, the Federal Government crowds out private credit, driving up interest rates.

With the strength of the U.S. ecomomy as well as the strength of the U.S. dollar, we have seen massive capital inflow into this country. In some respects, this capital inflow has helped to temper our own Federal deficit financing problems. Yet, at the same time, it has aggravated other segments of our economy. We have seen our foreign trading partners benefiting not only on their capital investments, but also from the strength of the dollar by making their goods much more price competitive. The result has been a large influx of imported goods into the United States and the crowding out of U.S. exports.

While there may be many solutions proposed here this morning, all of which I am sincerely interested in hearing, I believe our first priority should be to deal with the mounting Federal deficit. This is the opportunity we will all have in the next several weeks: To make an immediate, long-lasting and positive contribution to our trade deficit and exchange rate problems.

The **CHAIRMAN**. Good morning. We are starting today the first of a series of hearings on the trade deficit, the exchange rates on our dollar, whether there is a relation between the two, and I must admit as we start this subject, I find more experts at odds or at sea on this subject than I even do the subject of tax reform. And by at odds, I mean they are not quite as sure of their opinions as they seem to be in tax reform. I am not sure that in either case they are "righter" or "wronger" but they are more positive in the area of tax reform than they are in the area of the trade deficit and whether or not it is caused by the extraordinary exchange rate fluctuations, and in the last few years—or the last 2 years—the dramatic drop—or increase in the value of the dollar and the drop in our trade balance. The witnesses that we have today, this afternoon, and tomorrow probably are as good an aggregation of experts as we could get on this subject. I hope at the end of it we have some idea as to what we should do. I have read all of the statements that were in as of last night. If your statements weren't here by then, I have not had a chance yet to read them. They are in conflict, and I don't mean that in any critical way. I would be suspicious if they were all in agreement. I hope by the time we are done that we will have some idea, in addition to simply reducing the deficit, as to what perhaps we should do. Senator Moynihan was next, and then Senator Bentsen, I think.

Senator MOYNIHAN. Mr. Chairman, I would like to thank you for organizing these hearings, as we on this side and other interested parties had asked you to do. I would like to welcome our first witness, Mr. Colby Chandler of the Eastman Kodak Co., and Bob Roosa of Brown Bros., Harriman & Co., two New Yorkers. Mr. Roosa is well known to this committee and has been over many years. Once a Treasury official, always a Treasury proponent, we look forward to hearing from him. I think it is especially important, Mr. Chairman, that of all the businesses or the firms in this country from which we will hear on the impact of the dollar's value, I think alone and singularly the Eastman Kodak Co. has spoken out on this matter. For the first time, I think, in their century-old history, they have written to each of their 183,000 stockholders on the question of the dollar and the consequences. And they produced a document, "The Dollar and Eastman Kodak Company," which I would like to ask to be put in the record at this point, making a very simple proposition. Kodak is a wholly competitive concern in the world. They are the 10th largest exporter of American goods, an international firm known the world over. The more remote the places you get to in the world, the more you will see Kodak film canisters—at the tops of the Himalayas and the depths of the Amazon jungles. They have been in Japan. They have been operating in Japan for 50 years. There have been no complaints about their arrangement there. They have 15 to 18 percent of the market. They want to get more. They go head to head with Fuji on the price of film. But they cannot live in a world economy in which the dollar is so overpriced that their own exports are necessarily uncompetitive. They have estimated that in the last 4 years the overpriced dollar has cost the Kodak Company $1 billion in earnings. They make the point—not in any way in a threatening manner, but simply a statement of reality—that if this continues, the prospects of manufacturing here and selling abroad are going to just disappear, and the opportunities to manufacture abroad and sell here are going to become unavoidably attractive. And a firm such as Kodak could end up as a marketing firm, just as our automobile companies are on the verge of becoming marketing firms for actual machines built elsewhere and sold here. Some are labeled here but not produced here. I think we have an opportunity to hear from the real world on a very real world subject, and I thank you, Mr. Chairman, and I welcome our guests.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you very much, Mr. Chairman.

Mr. Chairman, I would like to congratulate you for holding these hearings on floating exchange rates and the international trading system.

For 4 years the administration has claimed that there is nothing wrong with the dollar's climb in value—indeed that it is a source of pride. The President has even gone so far as to say there is no such thing as an overvalued dollar.

Sometimes I wish I too could see the world through such rose-colored glasses. But I cannot—I see reality.

Mr. Chairman, the American wheat farmer is the envy of the world in his productivity and efficiency. Ask him if he believes the high dollar is a source of pride. Ask Caterpillar tractor—a company held up as a model to the world; a company long world-dominant in its field—as it begins to move facilities off-shore if it thinks there is no such thing as an overvalued dollar.

Everyone outside the White House can see the damage. Just 2 weeks ago Secretary of State George Schultz attributed over half the deterioration in our trade account to the dollar.

The dramatic appreciation of the dollar has many costs:

It makes U.S. products relatively more expensive and foreign products relatively cheaper thus reducing the competitiveness of our exports. Market share once lost may be very difficult to regain.

It has led highly efficient U.S. producers to shift production abroad. Such a move usually portends a permanent loss of jobs.

It has eroded the value of existing foreign investments.

What is less often recognized Mr. Chairman is that the high dollar has imposed costs on other nations as well. We tend to focus on their expanding markets and their newly won foothold in our markets. But there is another side to that coin as well.

The cost of dollar-denominated imports such as oil has skyrocketed.

Savings which might have been used to finance investment and long-term growth in these countries flowed instead into the United States. This in turn has meant upward pressures on interest rates as these countries seek to retain some savings. These higher interest rates further depress their economies.

The debt service burden for the LDC's grows with higher dollar interest rates and a higher dollar.

When the Bretton Woods system of fixed exchange rates collapsed and was replaced by a system of managed floating the world was a very different place. Then trade flows determined the supply and demand for a currency and so its value. The situation of the United States today was inconceivable: it would be impossible to have such huge fiscal and trade deficits and a rising dollar. How, however, capital flows exceed trade flows by about 25 to 1. The demand for dollars is determined not by a demand for U.S. goods but by its use in capital transactions. Thus today capital flows in effect drive trade flows: it is the exchange rate as much or more than the quality of the product that determines its competitiveness.

In addition, capital flows are much more volatile than trade flows. Today's system is much less stable than it was expected to be. Wide swings in currency values have hurt the trading system as a whole.

How long can an open trading system survive if nations feel they must resort to barter or bilateral arrangements to counteract exchange rate volatility?

How long can American companies be expected to try to compete with the equivalent of a 30 to 45 percent surtax attached to their exports and a comparable subsidy attached to competing imports?

Mr. Chairman, I recognize there is a positive side to our massive capital inflow. Without these inflows we would have to finance our Federal deficit from domestic savings. Interest rates would climb and interest-sensitive sectors and industries would be devastated even further. But I do not believe the path we are on now can be sustained.

What can we do?

Obviously, some of the burden for action lies here at home. We must act to bring our fiscal house in order. If we do so the Federal Reserve will be willing to loosen up some and interest rates will come down. Deficit reduction is a necessary condition for the health of the trading system—but I doubt it is a sufficient one.

Mr. Chairman I will be interested during these sessions to learn what these distinguished witnesses have to say about floating exchange rates and the international trading system. How can the volatility of exchange rates be reduced?

Is it possible to bring exchange rates more in line with purchasing power parities? If so, would such a change be helpful?

When and how should intervention be attempted?

What other steps make sense?

But, Mr. Chairman, one other major question remains: Can anything at all be done if the President refuses to see the problem?

I, for one, believe we cannot allow rose-colored glasses to blind us to the realities confronting the international trading system. Mr. Reagan may see nothing wrong, but everyone else does. We must not crucify our producers on a cross of the overvalued dollar.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. That was a voice from the West.

Senator BAUCUS. Sorry.

Senator BENTSEN. Yes. Mr. Chairman, I really want to congratulate you. I think your hearings are very timely in trying to figure out what the international floating rates of exchange actually do to trade. It is an issue of enormous importance. And the administration has paid so little attention to it, they haven't even bothered to appear. And that makes your attention to it, Mr. Chairman, all the more noteworthy and appreciated.

I was intrigued the other day by the President's statement at your stock exchange, Senator Moynihan. When they asked him what was going to happen to the administration's Economic Program over the next 4 years, he said, "We are going to turn the bull loose." Well, they certainly have, and it appears to me that it has found the china closet. When he was asked at a press conference in February about calls to rein in the overvalued dollar, he turned the bull loose. He said, "it really wasn't a problem, it was a blessing. He said I think the problem of the dollar today is that our trading partners have not caught up with our economic recovery." Now, that is what the President said.

In saying that, of course, he ignored the impact of 4 consecutive years of huge Federal budget deficits—and the effect they have had on the dollar. And that interests me because the President has submitted in each of those 4 years budgets with deficits from $100 to $200 billion. He submitted them, yet he blames the Congress for failing to curb the deficits. And then he calls for a constitutional amendment to make the very budgets that he submitted illegal. Finally, he steadfastly denies that those deficits have any harmful effect. The bloated dollar, he said, is not a problem of the Federal deficit; it is a problem of foreign economies.

The fact is, we don't know enough about the causes of these very harmful currency fluctuations. I am satisfied that those deficits in the U.S. Federal budget are one of the key causes, but we need to learn a lot more about such fluctuations before we come to grips with them, and that is why I think these 2 days of hearings are terribly important.

I noticed that Secretary of the Treasury Baker said things in recent days that send some hopeful signals, that the administration may at least be ready to enter into international discussions on currency exchange. I haven't seen anything from the President in that regard. But the problem that Senator Moynihan was talking about, the chairman was talking about, and Senator Baucus too—that we get in a situation where we are exporting our manufacturing base—is important. There is no way we can remain a great Nation without a diversified manufacturing economy in this country.

When I see Kodak and some of these others lose market share, I am concerned. You don't get market share back easily. You know, they have fought and fought and fought to achieve that kind of a position in the world economy. I was talking to the head of one of the largest companies in the country, and he said what we are going to do—and he said I have told my people—"we must retain that market share, so we are going to move our plants overseas. We are going to move them out there and hold that market share and hopefully someday we will bring the plants back here." But in the meantime, they will have invested hundreds of millions of dollars of the stockholders' money overseas and the jobs will go overseas.

This country can't continue that way. Global competition is just like a dash to the marketplace—a 100-yard dash—and with the disparities in the currencies, you give your competitor a 30- or 40-yard headstart. That is tough competition. So, you increase your productivity 20 percent in 1 year. I am not sure which company has been able to do that, but if there is one, then he would have it wiped out by what might happen to you in currency exchanges. It is pretty difficult to plan long-term capital commitments. It is pretty difficult to go to your board of directors and get that kind of a commitment to put the plant in the United States if there is going to be that kind of disparity in currencies. Mr. Chairman, I am very pleased you are doing this, and I look forward to learning a lot more from gentlemen like Bob Roosa and the others who will testify.

The CHAIRMAN. Senator Long?

Senator LONG. No, thank you, Mr. Chairman.

The **Chairman**. The administration has indicated that they would like to reserve testifying until after the Bonn summit. Hopefully, they will have something to bring back on this subject, but I think they did not want to position themselves ahead of time and have asked not to testify today or tomorrow but are willing to testify afterwards. We will start today with Mr. Colby Chandler, the chief executive officer and chairman of the Board of Eastman Kodak. I might say to all of the witnesses their statements in total will be placed in the record, and as I indicated earlier, to the extent that it was in last night, I have had a chance to read them all. I hope to finish these hearings on time, and that means with all the witnesses this morning, we are going to have to go right through this morning and through the noon hour, if necessary, because we have other witnesses coming on at 2:30 this afternoon. So, I would encourage the witnesses to stick with the time limits they have been given, and rest assured that you will not get away with just the statement—we will have ample questions when you are done. Mr. Chandler, go right ahead.

STATEMENT OF COLBY H. CHANDLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, EASTMAN KODAK CO., ROCHESTER, NY

Mr. **Chandler**. Mr. Chairman, members of the committee. I am Colby Chandler, chairman and chief executive officer of the Eastman Kodak Company, a 105-year-old manufacturer of consumer and professional photographic goods, information management products and systems, health science products, chemicals, fibers, and plastics.

The effect of the strong dollar on U.S. industrial competitiveness in the world marketplace is one of the most important issues facing American business today. I commend the committee for calling this hearing to focus on the issue, and I also appreciate the opportunity you have given me to appear here this morning.

Kodak has, from its beginning, been selling products throughout the world. We have regularly ranked among the top U.S. companies in export sales. In 1981 we contributed a positive $1.6 billion to the U.S. balance of payments. Since 1981, our trade balance contribution has slipped, declining to $1.4 billion last year. About 35 to 40 percent of our revenues come from overseas, and about half of that comes from products produced in the United States, where about 20,000 of our employees are in export-related jobs. Their jobs and many more around the world depend on Kodak products being purchased in free and open competition. However, today the strong dollar gives an unearned advantage to manufacturers abroad. For example, importers can sell at lower prices because such goods have been made at costs denominated in cheaper, local currencies, thus allowing those competitors to gain market share without sacrificing profits. Or, second, importers can increase profits by holding prices level, then converting dollars from U.S. sales to local currencies at advantageous rates of exchange. In either case, our products become more expensive when compared to similar ones made at nondollar-based costs. Consequently, we lose both sales and earnings.

Similarly in Europe, for each of the last 4 years, the exchange effect has been the same as handing our competitors a 15-percent price increase or forcing us to make a 15-percent price decrease. Few companies anywhere could survive a 4-year compounded negative effect of that magnitude. Let's look for a moment at the last 4 years. We can calculate part of the exchange rate's annual effect on earnings by translating our sales revenues abroad to dollars at the current and prior year exchange rates. In 1984 this calculation shows that the surge of the dollar reduced our earnings incrementally about 60 cents a share. Cumulatively, over the past four years, the strong dollar reduced 1984 earnings for Kodak earnings by $3.25 a share or more than $500 million. But that actually understates the situation. It fails to account for earnings foregone due to lost sales or lost margins. Using a conservative approach, counting the calculated value as only half the actual impact. We estimate our lost earnings per share in 1984 were actually $6.50. My next few comments will clarify our submitted statement in this regard. That $6.50 per share in 1984 represents $1 billion forfeited in that year. If you add the cumulative effects for 1981, 1982, 1983, and 1984, and compare with what the effect might have been had the dollar stayed at its 1980 level the loss in retained earnings is estimated to be $3 billion; $3 billion not available for investment in jobs, in research, or in expansion, and $3 billion not available on which to pay taxes.

Clearly, American multinational corporations have been dealt a serious blow by the strong dollar. They will do all in their power to cope. For Kodak suddenly moving manufacturing to other countries is not practical because of the long-lead time and the magnitude of investment required to construct a complex manufacturing plant. We have not been sitting idly by. Our manufacturing commitments are substantial. To ensure our technological lead, we invested more than $800 million in research and development last year, and we have budgeted $1.2 billion for capital improvements this year. In spite of that commitment, we have had to modify our approach in order to minimize the effects of the dollar. I do have just a bit more. May I finish?

The CHAIRMAN. Go right ahead, sir.

Mr. CHANDLER. Thank you. We improved productivity 13 percent last year. We consolidated manufacturing, purchased more foreign-made parts, and located some assembly and subassembly work in nondomestic locations. Perhaps, though, the most dramatic change has been the purchase of whole new lines of finished products manufactured abroad and supplied to us by other companies. Foreign purchases of parts and products during 1984 by us were up 100 percent over the prior year.

My point is this: Continuing inequity in currency values will force American companies—Kodak included—to trend more and more to offshore manufacturing. That raises two basic points. First, American's manufacturing base is vital. One recent survey in New York State shows that every manufacturing job generates three service sector jobs. And the second point was well stated by a leading retailer in my home city of Rochester who asked: What good will it do to have lower priced merchandise coming in from overseas if I have no consumers with jobs or dollars to spend? That man was perceptibly seeing the long-term effect.

We are not asking for special treatment. We do not advocate various protective measures. We continue to support free trade even though we are well aware that the abnormally strong dollar gives offshore manufacturers an opportunity they have not earned. But I also recognize that the issue of the dollar's strength does not yield to simple solutions. As we discuss more fully in our submitted white paper, its causes are numerous and complex.

The CHAIRMAN. I will have to ask you to wind down, Mr. Chandler.

Mr. CHANDLER. Thank you. I have only two paragraphs left. While low inflation and a strong U.S. economy have contributed to the dollar's strength, high interest rates and the huge budget deficit have worked to compound the problem. The deficit with its consequences for the dollar must be dealt with promptly. It threatens the future of American industry. We simply cannot give away our competitive advantages by letting the dollar run along continuously and relentlessly. Thank you very much.

The CHAIRMAN. Thank you, sir.

[Mr. Chandler's prepared statement follows:]

THE EFFECTS OF A STRONG DOLLAR BY COLBY H. CHANDLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, EASTMAN KODAK CO.

Mr. Chairman, members of the committee, I am Colby H. Chandler, Chairman and Chief Executive of Eastman Kodak Company—a 105-year-old manufacturer of consumer and professional photographic goods, information management products and systems, health science products, chemicals, fibers and plastics.

The effect of the strong dollar on U.S. industrial competitiveness in the world marketplace is one of the most important issues facing American business. I commend the Committee for calling this hearing to focus on this issue . . . and I also appreciate the opportunity you have given me to appear before you this morning.

I am not here to espouse economic theories. But I do want to share with you some quantitative information regarding the effect of a strong dollar on a major. U.S.-based multinational manufacturing concern.

Kodak has from its very beginning been selling products throughout the world. In 1983, we were the 10th largest exporting company in America, and last year our exports helped us achieve a positive contribution of 1.4 billion dollars to the U.S. balance of payments. [See Attachment A.]

In fact, we have regularly ranked in the top group of U.S. companies in export sales.

About 35 to 40 percent of our revenues come from overseas . . . and about half of that comes from products produced in the United States where about 20,000 of our employees are in export-related jobs.

Their jobs and many more around the world depend on Kodak products being purchased in free and open competition. However, today that competition is distorted.

A strong dollar gives an unearned advantage to manufacturers abroad who compete with U.S. manufacturers—in either our domestic or export markets. This means, for example, that in domestic markets:

Importers can lower prices of goods they sell here because such goods have been made at a cost denominated in cheaper, local currencies—thus allowing those competitors to gain market share without sacrificing profits; or,

If they choose, importers can increase profits by holding prices level, then converting dollars from U.S. sales to local currencies at advantageous rates of exchange.

In supplying international markets, Kodak's approach has been one of manufacturing balance. About half of the products we sell abroad are manufactured here. The other half represents products manufactured in facilities outside the U.S., often with materials supplied from our U.S. resources.

In either case, our products become more expensive when compared to similar ones made at non-dollar related costs. Consequently, we lose earnings because of decreased margins, lower volumes, or both.

For example—in Europe—in each of these last four years, the exchange effect has been virtually the same as handing our competitors a 15 percent price increase or forcing us to make a 15 percent decrease. Few companies have total margins as high as 15 percent. So a one-year negative effect, to say nothing of a four-year compounded negative effect of that magnitude, is something most companies anywhere could not survive.

I am mindful of the record-high levels the dollar has reached this year and also of its moderation during the last few weeks, but look for a moment at the previous four years. [See Attachment B.]

We can calculate part of the exchange rate's annual effect on earnings. This can be done by simply translating our sales revenues abroad back to dollars, then comparing that with the value that would have resulted had the dollar stayed at its value for the prior year.

The upward surge of the dollar from 1983 to 1984 reduced our earnings in the latter year by about 60 cents a share. The cumulative effect of the strong dollar over the past four years reduced Kodak's 1984 earnings by about $3.25 a share or more than 500 million dollars. [See Attachment C.]

That actually understates the situation. It fails to account for earnings foregone due to lost sales or lost margins. Our estimate that this calculation is indicative of only one half to one third of the currency effect.

Using a conservative approach—counting the calculated value as only half of the actual impact—we estimate our lost earnings per share were actually $6.50 or about one billion dollars. That is the cumulative effect of four years of such changes on 1984 earnings. If we had not incurred those currency losses, our earnings would show a four-year 15 percent compounded increase from 1980. Instead, our results were 20 percent below those of 1980.

If we total our earnings over the past four years and compare them with what they might have been had the dollar stayed at its 1980 level, the loss in retained earnings would come to an estimated three billion dollars. Those dollars were not available for investment in jobs, in research, or in expansion . . . or for payment of taxes to federal, state and local governments.

Clearly, American multinational corporations have been dealt a serious blow by the strong dollar. They will do all within their power to cope, but there are limitations.

For Kodak, suddenly moving manufacturing to other countries is not very practical because of the lead time and the magnitude of investment required to construct a complex manufacturing plant.

But we have not been sitting idly by waiting for the dollar to come down. In a growing worldwide photographic market, we are continuing to work hard to maintain our positions.

To ensure our technological lead, we invested more than 800 million dollars in research and development last year. We have had an intensive effort underway for several years to improve productivity, and half of our 1985 capital budget will be directed toward productivity and quality improvements.

Our efforts have been successful in that our 1984 productivity was up 13 percent, or nearly four times the national average (which is at its highest in thirteen years). Productivity efforts have included not only process and equipment modification . . . but also reductions in worldwide employment which, at the start of this year, was down nearly 2 percent from 1980.

Kodak manufacturing commitments in the U.S. are substantial. To grow our existing base, we have budgeted more than 1.25 billion dollars for capital improvements in the U.S. during 1985. In spite of that commitment, we have had to modify our traditional mode of doing business in order to minimize the effects of the increase in value of the dollar.

We have consolidated the manufacture of many products. We have located a modest amount of assembly and sub-assembly work at our locations outside the United States. We have bought more foreign-made parts from other manufacturers.

These efforts are all new to us, but perhaps the most dramatic change has been the purchase of whole new lines of finished products manufactured abroad and supplied to us by other companies. Foreign purchases of parts and products during 1984 were up more than 100 percent from the previous year.

My point is this: continuing inequity in currency values will force American companies, Kodak included, to trend more and more to off-shore manufacturing.

Being competitive in manufacturing cost is always our objective, but even the cost advantages of a 13 percent productivity increase are not sufficient to offset the dramatic appreciation of the dollar.

Despite our use of a sophisticated currency trading operation, our exposure to currency fluctuations remains severe. And, here again, what is possible is very small in comparison to what is needed.

It seems to me that the U.S. is in a serious situation with the very survival of its manufacturing base at stake. At the very least, there has already been a setback that will prevent many companies, in the foreseeable future, from returning to former performance levels. Some industries may already be at the point where projected return on investment cannot justify construction of new plants, or even modernization of existing facilities.

We are not asking for special treatment, and we do not advocate import surcharges, quotas or other protectionist measures. We continue to support free trade even though we are well aware that the abnormally strong dollar gives offshore manufacturers an opportunity which they have not earned and which U.S. companies have not fumbled away.

But I also recognize that the issue of the dollar's strength does not yield to simple solutions. As we discuss more fully in the attached White Paper on the Strong Dollar, its causes are numerous, complex and interwoven. [See Attachment E.]

While low inflation and a strong U.S. economy have contributed to the dollar's strength, high interest rates and the huge federal deficit have worked to compound the problem.

Over the past 10 years, the deficit has increased from less than one percent of the U.S. Gross National Product to nearly five percent. Financing this deficit fuels real interest rates, which are already high by historical standards and generally higher than rates of return available elsewhere.

Borrowing made necessary by the public debt contributes to high interest rates, which, in turn, contribute to the continued strengthening of the dollar—beyond what economic realities would suggest.

The deficit—with its consequences for the dollar—must be dealt with promptly. It threatens the future of American industry. We simply cannot give away our competitive advantages by letting the dollar continue to rise relentlessly.

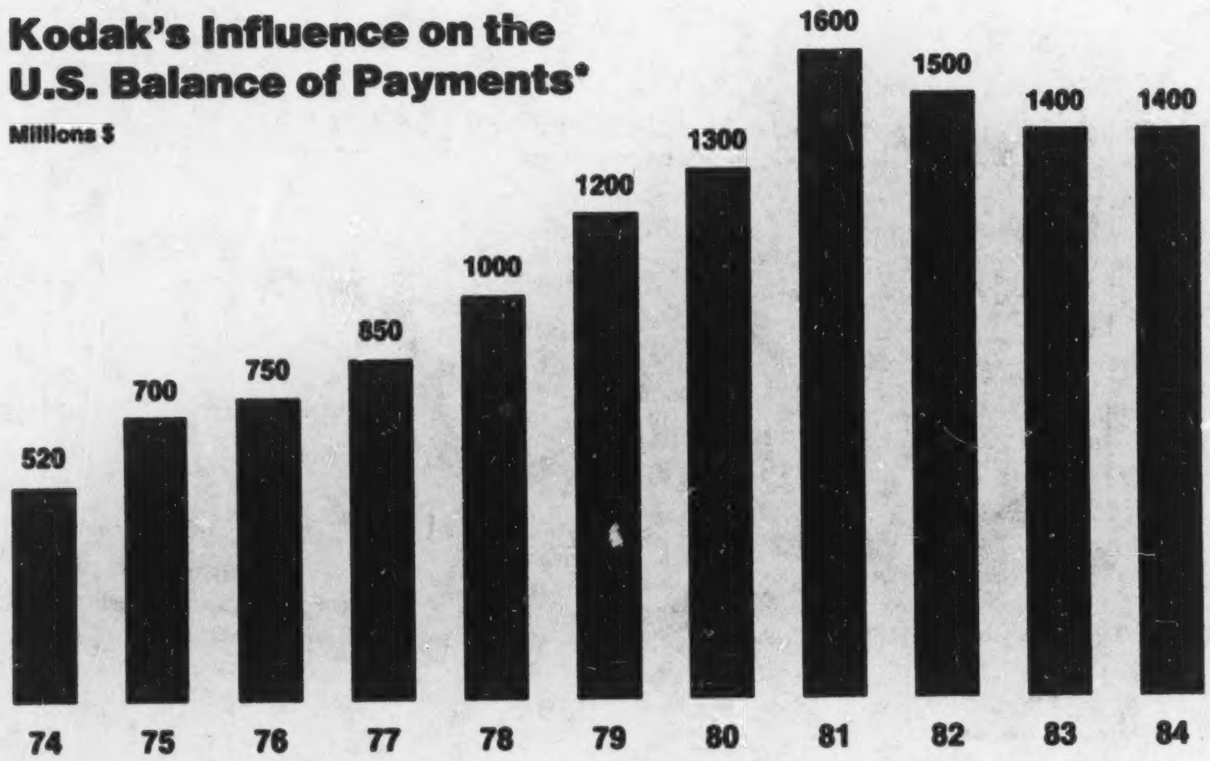
I would like to conclude by making just three brief points:

First, we view America's manufacturing base as vital. It is the wellspring of our economy. One recent survey in New York State shows that for every job created by manufacturing industry, another three jobs are generated in the service sector.

Second, we need to question the ultimate worth of relying on grand-scale importing of goods made cheaper by virtue of the strong dollar. A leading retailer in my home city of Rochester has asked this question: "What good will it do to have lower price merchandise . . . if I have no consumers with jobs and dollars to spend?"

And, last, let me emphasize that your work and leadership in seeking fair, direct solutions is worth the strongest investment of time and talent. We hope to help you make Americans more aware of the problems we face and the solutions we seek. In fact, just last month we sent a special letter to Kodak shareowners discussing the points we have raised here. [See Attachment F.] In their behalf, we again commend your initiative in examining this issue.

ATTACHMENT A



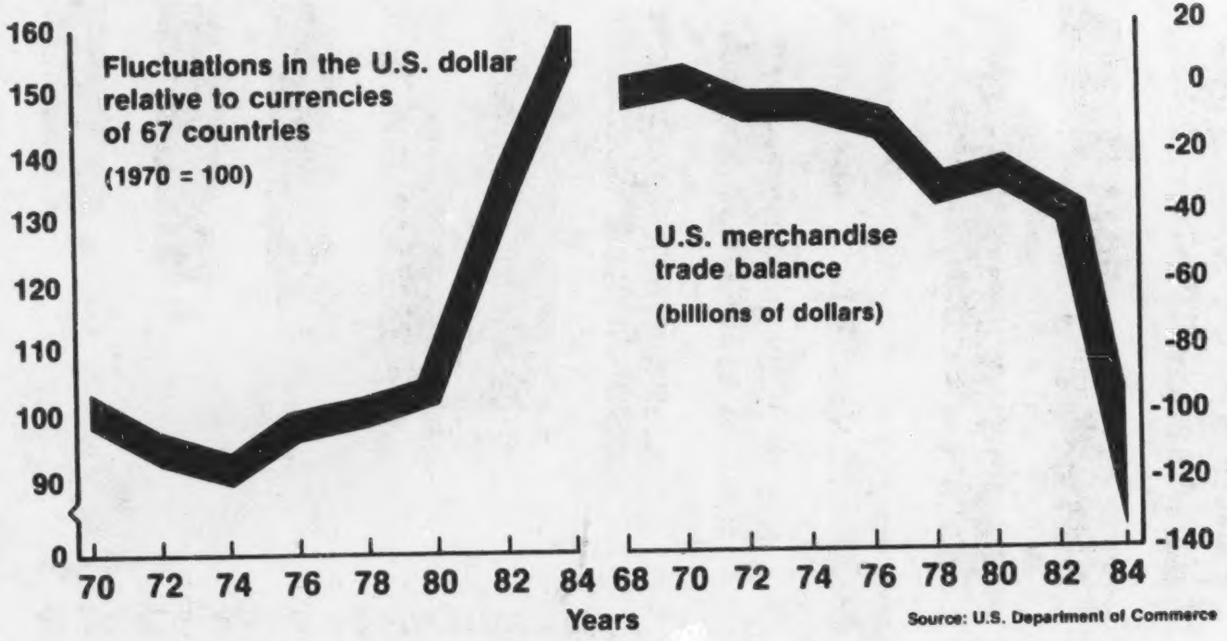
Kodak's Influence on the U.S. Balance of Payments*

Millions $

* The excess of exports, dividends, royalties, and other income from abroad over imports, new dollar investments outside the United States, and dividends to shareowners in other countries.

ATTACHMENT B

U.S. Exchange Rate and Trade Deficit



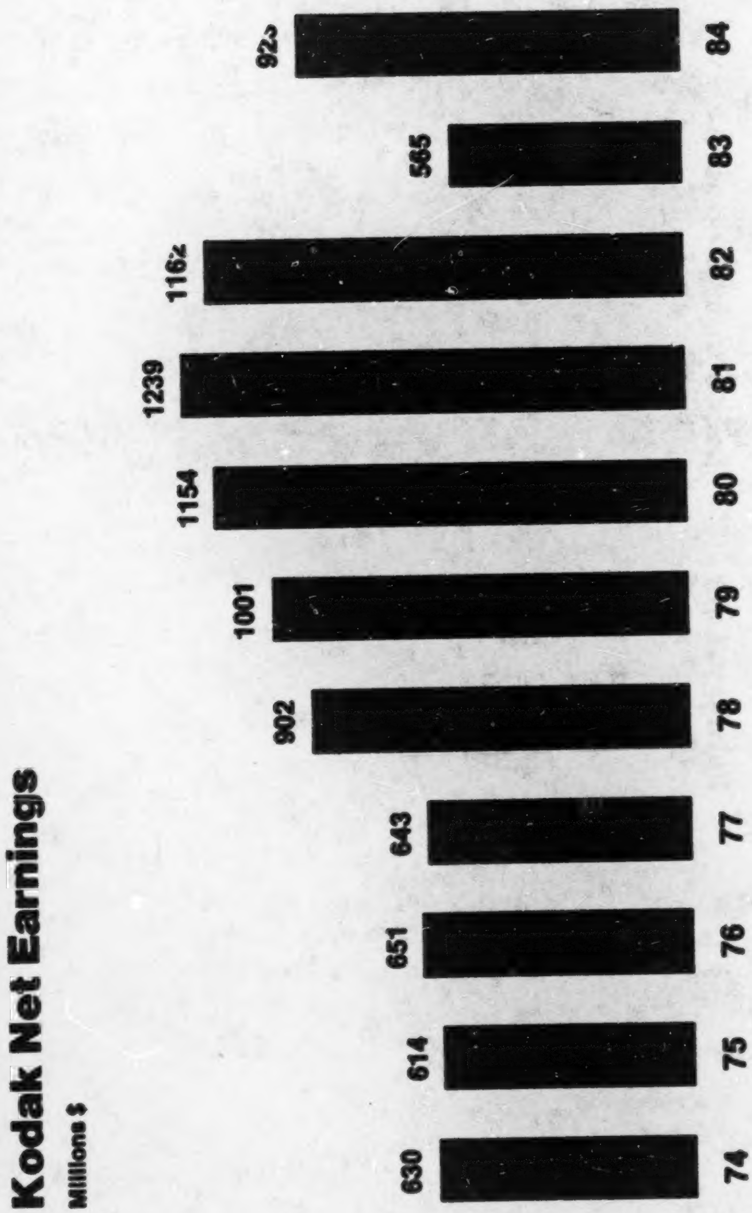
Source: U.S. Department of Commerce

ATTACHMENT C

Eastman Kodak Company — Effect of Dollar (Year to Year)

	Earnings Lost ($ million)	Lost Earnings/Share ($/share)
1981	164	1.00
1982	164	1.00
1983	107	0.65
1984	100	0.60
TOTAL	**$535**	**$3.25**

ATTACHMENT D



Kodak Net Earnings

ATTACHMENT E

White Paper on the Strong Dollar

WHITE PAPER ON THE STRONG DOLLAR

CONTRIBUTING FACTORS

The factors contributing to the strong dollar are numerous, complex and intertwined. An historical event which helped set the stage for today's strong dollar (as well as the weak dollar of the late 1970's) occurred in 1971 when the last links between the dollar and gold were severed. After that date, currency values were allowed to float and many factors started to influence currency values. The following widely recognized factors are presently supporting the strength of the dollar:

1. Safe Haven. The United States is currently considered to be a safe haven for investment because of our large and growing economy, our political stability and our recognized position as a world leader.

2. U.S. Economic Recovery. Since the last recession, the U.S. economy has recovered sooner and at a faster rate than the other economies of the world. The resultant expectation of greater growth in the U.S. attracts foreign interests.

3. Capital Inflow. During the last few years there has been a large net capital inflow into the U.S. which has added to the strength of the dollar. This is a relative phenomenon in that most data indicate that the absolute capital inflow into the United States has not risen significantly; however, the capital outflow from the U.S. has dropped considerably as domestic banks have cut back on their loans to developing countries.

4. High Real Interest Rates. Although recently U.S. interest rates have come down several points, our rates still remain high when compared with interest rates of other countries in a context of expected low U.S. inflation and continued economic growth.

WHAT MIGHT BE DONE ABOUT THESE FACTORS?

The U.S. could intervene in the currency markets to drive down the value of the dollar. But there is reasonable agreement that such an effort would have only limited effect on a day-to-day basis and would not give rise to stability in the currency markets.

Often with international issues, a certain amount of "jawboning" can be effective. For example, the Administration might make statements that the dollar should be lower and our policy will be to move it down in an orderly manner. However, financial markets are typically fragile and such statements may result in panic. Martha Seger, Federal Reserve Board governor, has warned that "should market participants perceive, rightly or wrongly, any shift in policy or economic circumstances that would make the growing proportion of dollar assets in portfolios less attractive, the dollar would drop precipitously, with potentially disruptive effects on financial markets." Such a sharp drop in the dollar's value would give the U.S. economy an inflationary shock.

Another approach would be to study and perhaps modify the floating exchange rate system in cooperation with other major countries. Although such an effort might take a considerable amount of time before various countries would even gather to talk, and an even longer period before agreement on any solution, nevertheless serious consideration should be given to pursuit of a multilateral accord.

The difficulty with a multilateral approach is that many other countries are benefitting from the strong dollar which makes foreign goods more price competitive and has resulted in a large influx of imported goods into the U.S. Some countries (importers of dollar-denominated oil) may be willing to negotiate but many other countries may not have any real incentive to participate in a multilateral accord. Consequently, the U.S. should also seek unilateral action it can take in an effort to moderate the dollar.

Looking now at the contributing factors referenced above, no one would seriously urge action to reduce the safe haven aspect of the United States.

Similarly, no one would suggest action to dampen the current U.S. recovery which has been somewhat Utopian with its accompanying low inflation and good employment growth. Conversely, there is not a lot more the U.S. can do to enhance the recovery in the rest of the world. As it is, we are purchasing an ever increasing amount of goods from abroad, which resulted in a 1984 trade deficit of $123 billion. Even with those purchases, the other economies have not recovered as rapidly as the United States.

Capital inflow into the U.S. might be limited or prohibited in order to reduce the value of the dollar. Such action would be contrary to the general U.S. commitment to open markets and economies. It would also be untimely after our recent success in pressuring the Japanese to open their capital markets in order to raise the value of the yen. Restraints on foreign capital are not the answer for two reasons: it would put significant upward pressure on interest rates and would lead to protectionist action abroad which would further hurt our already suffering exports.

That leaves interest rates as a primary area where U.S. policy has the potential for significant influence on the value of the dollar.

INTEREST RATES

There is widespread agreement that the competition between rapidly increasing, record level federal government borrowing needs and the private credit needs of a growing economy is placing an increasing demand on the nation's savings pool. The result of this competition has been referred to as a "crowding out" phenomenon causing interest rates to go up as fewer dollars are available to meet increasing credit needs. Arthur Levitt, Jr., CEO, American Stock Exchange, has referred to this as a "bidding up" process during the current economic recovery in which our public and private sectors are engaged in a bidding war for finite credit resources.

However, as long as the growth potential of the U.S. is perceived as greater than that of our trading partners, foreign capital flows into the U.S. to augment our savings pool. A continuing net inflow of foreign capital in search of maximum return helps finance our growing credit needs and eases somewhat the upward pressure on interest rates.

Would a greater influx of foreign capital be helpful in pushing interest rates down? Perhaps it would, but with the already open market/economy policy of the U.S., there probably are no actions we could realistically take to increase foreign investment. Even if we could induce more investment, it would raise nationalistic concerns about undue foreign ownership in this country. More importantly, it would also cause the dollar to increase in value and further exacerbate our basic problem.

The growing U.S. economy is driving the increase in private sector credit needs -- one of the ingredients in the interest rate bidding war. No one wants to dampen the current U.S. recovery nor should we attempt to do so. Assuming we did choose to slow the recovery, the only effective way is to tighten the credit market which, in turn, would drive up interest rates!

Another approach which the U.S. might take in an effort to drive down interest rates would be for the Federal Reserve to embark on a policy of greater monetary growth. Paul A. Volcker, Chairman, Federal Reserve Board, has acknowledged repeatedly that interest rates are too high for the long-term health of the U.S. or the world economy. But attempts to accomplish the desired goal by excessive monetary growth would provide only very short lived relief at best and would soon lead to inflation. Depreciation of the dollar by inflationary policies would have an adverse impact on our current economic recovery.

Volcker's view is that the greatest contribution the Federal Reserve can make to lasting prosperity lies not in increasing monetary growth but in fostering the expectation, as well as the reality, that we can sustain the hard-won gains against inflation. His position is that as we maintain progress against inflation, interest rates should decline.

FEDERAL DEFICIT

The only remaining part of the interest rate equation to be examined is federal government borrowing. In 1984, the outstanding federal borrowing (excluding tax-exempt notes and bonds) was nearly 48% of the total net demand for credit. Those federal borrowing needs were driven by our record high and growing federal deficit of over $200 billion for 1984. Thus, the federal deficit appears to be the most significant point of attack on the problem of interest rates, which in turn relate to the value of the dollar. The deficit (unlike exchange rates) is the one area in which the U.S. could take prompt, unilateral action.

CONCLUSION

Our first priority should be to deal with the mounting federal deficit. There should be a reasonable level of balance and fairness to any approach to deficit reduction but any attempt to close the gap between federal spending and revenue should first be directed toward the spending side. There should be few if any "sacred cows", and all areas of spending should be reviewed for possible modifications, including defense and assistance programs. Careful attention should also be given to the various cost cutting measures proposed by the Grace Commission.

Tax increases in an effort to raise revenue to the level of federal spending cannot be a preferred solution. Increased taxes reduce the earnings remaining to go into the nation's savings pool. A smaller savings pool available to meet growing credit demands would lead to higher interest rates. However, if a large deficit still remains after adopting all rational spending reductions and cost cutting measures, then and only then should attention be given to a balanced effort to increase revenues.

Exchange rates, in part, reflect a mix of fiscal and monetary policy. Thus, a more restrictive fiscal policy (in the form of significant spending restraint) may require modest relaxation of monetary policy in order to thread the eye of the needle heading to termination/reduction of the dollar's rise without also increasing inflation or dampening economic recovery.

A secondary objective should be to work with our trading partners to review and possibly modify the operation of the floating exchange rate system, or to determine what possibilities exist for greater coordination of action in fiscal and monetary policies. Such efforts could, over time, create a world economic interaction which might moderate the dramatic swings in value of various currencies and avoid future occurrences of the present problem with the dollar or with other currencies.

ATTACHMENT F

A Letter To Kodak Shareowners

Since the summer of 1980, the U.S. dollar has risen in value an unprecedented 80 percent or more against major worldwide currencies. While this economic trend has been attractive to Americans who travel abroad or choose to purchase imported goods, it has had a decidedly negative effect on U.S. manufacturing companies.

The strong dollar has resulted in a decrease of several percentage points in U.S. economic growth, helped to produce a trade deficit of $123 billion in 1984 and, according to some, eliminated more than 2 million manufacturing jobs. At Kodak alone, some 20,000 jobs depend upon exports.

Impact of the Dollar

Kodak, as a multinational company with about 40 percent of its sales outside the U.S., has not escaped the impact of the artificially strong dollar.

It affects us in several ways:

(1) importers can lower prices of goods they sell in this country because such goods have been made at a cost denominated in cheaper local currencies; thus, importers can "buy" market share without sacrificing profits;

(2) or such importers can increase their profitability by holding prices level and then converting the dollars from U.S. sales to the home currency at advantageous rates of exchange;

(3) since about half of Kodak's sales abroad are based on goods manufactured in the United States, our products become more expensive in other lands, making them less attractive in world markets; and

(4) finally, since Kodak results are reported in dollars, the company must earn more local currency to make the equivalent amount of U.S. dollars, thus depressing sales and the consequent earnings.

The Cumulative Effect

In 1984, Kodak net earnings totaled $923 million, an increase of 63 percent over the depressed levels of 1983. Earnings per share reached $5.71—up from $3.41 in 1983. Yet the upward surge of the dollar actually *reduced* our earnings by about $.60 a share in 1984 alone. If the dollar remains at its current value, 1985 earnings will be adversely affected by more than they were in 1984.

During the past four years the strengthening dollar has reduced the company's earnings by a cumulative $3.25 a share, or by more than $500 million. Even that amount understates the case, as it fails to account for earnings lost due to dollar-related adverse competitive conditions at home and abroad. Altogether, Kodak earnings may have been reduced since 1980 by at least $1 billion because of the dollar's strength.

This challenge is affecting all U.S. companies operating in global terms. Kodak believes in free trade; we do not advocate protective tariffs and import quotas. But while the company welcomes fair competition in a healthy worldwide marketplace, the abnormally strong dollar encourages imports while restricting the ability of U.S. producers to market their goods and services at home and abroad. In effect, this abnormality provides our competitors with an *unearned* opportunity.

Dedicated to Growth

Kodak is deeply committed to its businesses. The company has budgeted $1,517 million for capital improvements in 1985, with 80 percent of this amount allocated to investments in the U.S. Last year, we spent more than $800 million on research and development, again mostly in this country. In short, we are taking large steps to modernize and improve our plants, to increase productivity, and to innovate for the future. Yet we continue to experience the dollar's record-shattering march on other currencies of the world, in a way that restricts earnings and, for shareowners, the dividends those earnings yield.

Kodak does not believe the issue of the dollar's strength lends itself to simple solutions, as the causes for it are numerous, complex and interwoven. Due to the gravity of this problem, however, we are urging the government to take action on this issue.

Contributing Factors

While low inflation and a strong U.S. economic recovery have contributed to the dollar's strength, high interest rates and the huge federal deficit have worked to compound the problem.

Many believe that the deficit is the other crucial economic problem facing the nation today. Over the past 10 years, that annual deficit has increased from $6 billion to $185 billion, or from less than one percent to nearly five percent of the U.S. Gross National Product. Financing this deficit fuels real interest rates, which are already high by historical standards and generally higher than rates of return available elsewhere.

Borrowing made necessary by the public debt contributes to high interest rates, which contribute, in turn, to the continued strengthening of the dollar—beyond what economic realities would suggest.

A Time for Action

Kodak believes the nation will mortgage its future unless a vigorous attack on the federal deficit is mounted and, further, that this deficit—with its consequences for the dollar—threatens the future vitality of American industry. The rapid compounding of interest on the federal debt makes this a problem of top priority. In two Presidential elections, Americans have rejected tax increases and indicated their desire to limit the size of government. Congress should now address the need for the necessary spending restraints.

In our judgment, the strong dollar and the deficit are the two most critical economic issues facing the nation today. We have made our position on these bipartisan matters clear to representatives of government, and we will continue to voice our strong concerns. We urge Kodak shareowners to do the same.

Colby H Chandler

Colby H. Chandler
Chairman and Chief Executive Officer

K R Whitmore

Kay R. Whitmore
President

The CHAIRMAN. We operate in this committee on a first-come, first-served basis on asking questions. The first one who was actually here was Senator Heinz, who had to go and testify at the Rules Committee, as I understand, and Senator Moynihan was second. Senator Heinz, do you want to go first?

Senator HEINZ. Mr. Chairman, I appreciate that. I will be very brief. Rather than question a witness that I haven't heard, I would just like to make a couple of observations on our hearings. I do commend you for holding these hearings. They are timely and they are relevant. Our trade deficit has reached $123 billion and, ironically, the dollar during the time we have been building up this huge trade deficit has been appreciating over 50 percent against a basket of foreign currencies. I think the consequences of the status quo are disastrous. I think that is beyond debate. My subcommittee—the Banking Subcommittee on the International Finance and Monetary Policy—has held hearings on this subject virtually every year since 1981. Last year we had witnesses as diverse as Paul Volcker, Martin Feldstein, Fred Bergsten, and they all agreed as to the seriousness of the problem—the overvaluation of the dollar—and indeed specifically that it was not only causing severe economic dislocations, but it was putting the equivalent of a tax on our exports, as Mr. Chandler has in substance testified, and providing a subsidy at the same time for imported goods. And all agreed that the dollar's strength was more reflective of worldwide capital flows than trade flows and that this situation could not continue for long without setting in motion what can only be described as the deindustrialization of America. And I suppose we ought to throw into the deindustrialization of America the depopulation, at least insofar as farmers are concerned, of rural America as well, because those are the two main casualty groups.

Unfortunately, with the exception of Dr. Bergsten, no one had specific policy recommendations for fixing the current exchange rate system in order to make it more reflective of international trade relationships and realities. So, we are planning, depending on these hearings, further hearings on this subject this spring, Mr. Chairman.

The administration's policy on the dollar until recently can best be described as "benign neglect." What is worse, that policy has been pursued with considerable fanfare and pride. I recall at our hearings back in 1981 that then Assistant Secretary of the Treasury, then Marc Leland, announced unequivocally that the administration's policy was going to be not to intervene to influence the value of the dollar. In my judgment, that was the wrong policy, and what was worse was to announce it publicly and thereby remove from the market a cautionary impact of uncertainty. We have witnessed the fruits of that neglect over the past 4 years. Had we pursued a more ambiguous approach and one designed to wage a degree of psychological warfare on the exchange markets, I suspect the result would have been a far less dramatic appreciation of the dollar. Now, I suspect that at this point the genie is out of the bottle. It may be too late for that option, and more drastic proposals are going to have to be considered. One of them is the general import surcharge that has been discussed a great deal. Another is a broader systematic reform which could mean an end to the freely floating exchange rates that we have had for the last decade. Like other members of the committee, I don't particularly welcome measures like these, but I expect many of our witnesses today and tomorrow will warn us that failure to act now will leave no choice but to take more serious, more drastic, and maybe somewhat more counterproductive action later. There are some recent signs—most notably from the Secretary of the Treasury, Jim Baker—that concern about the dollar has begun to penetrate the higher levels of the administration. And there does seem to be a new willingness to take the problem seriously and discuss it openly. Perhaps these hearings will stimulate some new thinking there as well. The alternative, as I have mentioned, is literally the deindustrialization of America, the shipment of our factories, our production, and our jobs overseas. Already major companies in this country are announcing plans to close down American facilities and build new ones in Asia. That kind of action is frankly irreversible, once taken, and the tragedy of the last 4 years is that we have brought it largely upon ourselves. I hope that these hearings, added to those that I and others have held in the past, will alert both Congress and the administration to the dangers of benign neglect and will lead to a more aggressive trade policy. Thank you very much, Mr. Chairman.

The **CHAIRMAN**. Thank you. The order that I have is Moynihan, Packwood, Baucus, Bentsen, Long, and Danforth. Senator Moynihan?

Senator **MOYNIHAN**. I would like to give Mr. Chandler a little more time, if I could just yield it to him, and to say that as a firm functioning in the real world, you have seen the value of the dollar seem to become disengaged from the value of products and increasingly reflect some other kind of exchange relationship. Do you have any sense of what happened that you could tell this committee?

Mr. **CHANDLER**. I would certainly encourage listening to some monetarists who are skilled in this field, but it seems to me that when you look at the interest rates on Government bonds in the United States versus foreign, there is about a 70 basis point spread for the last 3 years, which is a bit ironical considering that this is a safe haven for money, that we are paying 70 basis points more than other countries. I think that clearly reflects the demand for dollars to fund the deficit. Now, correcting a deficit is a slow process, and as much as we urge it, and as much as we urge it by reducing Government expenditures, it will be a slow process. Intervention in correcting the currency market is a real possibility which I believe must be undertaken very carefully.

Senator **MOYNIHAN**. Could I press you on that, sir? There is a great deal of talk about balancing the budget, and there is this stop-me-before-I-kill-again amendment being proposed. [Laughter.]

But the agreement that has been reached between our distinguished former chairman, the majority leader, and the White House about the budget resolution—that we were supposed to take up yesterday and didn't—adds about $425 billion to the deficit in 3 years. That is the deficit reduction package. So, we are not going to get that. Absent that, in the real world, what would you do? You would think in terms of intervention?

Mr. **Chandler**. Yes; and I would turn to some sophisticated monetarists—and I believe there will be some testifying here today—who could in detail say how to do that, but I do think that that is working on curing the symptom rather than the disease.

Senator **Moynihan**. Yes, sir, but in the real world, that may be sometimes your only actual option.

The **Chairman**. Excuse me. When you said curing the symptom, did you mean interfering in the exchange rates?

Mr. **Chandler**. Yes.

The **Chairman**. All right.

Senator **Moynihan**. Again, thank you very much, Mr. Chairman. We have had a lot of persons come before this committee and they wanted one of two things. Either they wanted quotas, or as one of them most recently said, they wanted their share of the Japanese trade deficit. Here is someone who has come to talk about America, and we thank you for it.

Mr. **Chandler**. Thank you.

The **Chairman**. I noticed in your statement that you said you are a chemist, not an economist. That does not disqualify you from testifying in economics in any way, shape, or form. You are more qualified than most of the people who come before this committee, regardless of your academic training and background.

Mr. **Chandler**. Thank you.

The **Chairman**. Do you think that—I want to go a little further than what Senator Moynihan said—if this budget package that we are considering is adopted—if it is adopted, and that is "iffy"—I don't know if we have the votes to do it or not—we indeed do lower the deficit from an aggregate of about $700 or $725 billion over the next 3 years to $400 to $425 billion. At least, it is a step in the right direction, and if we were to project that out, the deficit is narrow because a good portion of that is achieved by eliminating programs. So, your savings compound year after year. If that budget package is adopted and if the deficits start moving toward zero over 6 or 7 years and people who lend money have confidence that we have enacted the laws to get there, will that in and of itself be enough to reverse this rather dramatic situation you currently describe?

Mr. **Chandler**. As we have said, it is a very complex matter, and it is natural to want to have simple one-to-one cause and effect understanding of relationships, and I do not think that applies here. However, I would believe that a near affirmative answer to your question would be appropriate.

The **Chairman**. Would be what?

Mr. **Chandler**. A near affirmative answer, that in a practical sense, it isn't reasonable for us to expect this to be corrected overnight. We would hope that the endless increase in the value of the dollar would be truncated and that we would see some reversal. And I think that American business can live with a solution that over time restores our deficit to something like 2 percent of GNP, which is a more historically normal relationship, and it would seem to us that that is a prudent course.

The **Chairman**. If I may paraphrase it, what you are saying is that if it isn't the only step, it is certainly a major step in the right direction.

Mr. **Chandler**. Yes.

The **Chairman**. What do you think about floating versus fixed exchange rates? Let's assume we are moving down on our deficit and we have adopted this budget package. Would you at that stage leave the exchange rates floating, or do you think we should go back to some kind of fixed rate?

Mr. **Chandler**. Our feeling is that a purely fixed rate would not be the way to go. We would not want to return to that. There are compromise ideas, partially fixed, which could be considered. I think on balance I would rather see us work on the fundamentals of deficits and managing trade and making American companies more competitive and then let the currency markets determine the value. What we have today is this unusual demand for capital coming into this country which does not result in a free market for the currencies. The competitiveness of American companies is very key here, and we have two problems there. One is we penalize savings in America. If we could reward savings with our tax structure and supply a source for credit, and second, we double tax corporate dollars. We do discourage capital formation, and if we could encourage capital formation and encourage savings, American companies in the multinational world markets would be more competitive.

The **Chairman**. I am tempted to ask you whether you think the Treasury reform bill moves us in the direction of encouraging savings in capital formation——

Senator **Moynihan**. Go ahead, Mr. Chairman.

The **Chairman**. No, no. That is for another time. [Laughter.]

Does it make any difference if we close the deficit by cutting spending or increasing taxes?

Mr. **Chandler**. I think it does, yes. I think that cutting spending is clearly preferred because raising taxes increases the burden on the productivity sector of the economy.

The **Chairman**. If we do nothing, is Kodak going to have to do the equivalent of indexing its foreign contracts or something like that to accommodate for tremendous fluctuations in currency?

Mr. **Chandler**. I am not sure we can do that.

The **Chairman**. I am not sure you will have to.

Mr. **Chandler**. We do hedge our billings in the currency market, and essentially in terms of the time lapse between shipment of the product and the remittances, we are quite effective in hedging that switch in currencies.

The **Chairman**. How do you do that?

Mr. **Chandler**. Buy forward. We buy foreign currencies forward, and in the last 4 years we have offset potential losses of $112 million. In other words, those numbers I have given you would be about $100 million worse——

The **Chairman**. I take it that because of the volatility, you have got a fair number of personnel devoted to this sole problem of the exchange rates and how much foreign currency to purchase and when and where?

Mr. **Chandler**. That is correct. We do.

The **Chairman**. Senator Baucus?

Senator **Baucus**. Thank you, Mr. Chairman. Mr. Chandler, my questions really follow up on the ones asked by my colleagues.

First, I would like to begin by saying how impressed I am with your testimony that although your company's productivity has increased 13 percent—four times the national average—still the high U.S. dollar is causing you to lose market share and earnings. I wonder if you could describe in a little more detail how difficult it will be for Kodak to regain its market share when the dollar begins to fall against other countries' currencies? Could you describe what you would have to go through and what the prospects are of regaining your market share?

Mr. CHANDLER. There are two aspects of that—the market aspect and the manufacturing aspect. In the marketplace, as has already been said by members of the committee, regaining market share is extremely difficult. It is usually done by foregoing profits and cutting prices in order to reestablish a market position, and that is done at great sacrifice to earnings.

Senator BAUCUS. So, that would mean an even further drop in earnings?

Mr. CHANDLER. Correct. Yes. Now, a really more serious matter—and long term, because it is a long-term factor—is reestablishing your manufacturing capability. Once a mature industry, such as the chemical industry, is in the position of shutting down its plants, I think it is highly unlikely that those plants or plants like them can ever be rebuilt under our current economic situation. The return on investment is not attractive enough to justify putting the money in the plants. What we have now in America are established manufacturing facilities in which plants are largely depreciated, and the investment being made currently is to keep the plants upgraded, and that is a much smaller incremental investment year by year than building entirely new plants. Now, if we were to shut down those plants and 5 years later try to start over, that would be equivalent to starting brand-new factories. Now, that would not swing.

Senator BAUCUS. Now, I suppose to some degree that leads us to the cost of capital. Is that correct?

Mr. CHANDLER. Yes.

Senator BAUCUS. Would you go into that now? Why is return so low?

Mr. CHANDLER. It is a free marketplace. The competition in the marketplace—some people like to use the term it is the fact that we are running below capacity. When factories are running below capacity, the price tends to pass the benefit onto the consumer, and I am all for that—I am not trying to criticize that—but it does, in mature industries reduce the return on investment to a marginal level so that the poor producers are forced out.

Senator BAUCUS. And why will the plants not be started up again? Or why will you not be able to build new plants?

Mr. CHANDLER. All right. I took hypothetically a 5-year period. In that period of time, obsolescence would completely render a 5-year-old plant as not usable, and it would probably be cheaper to build a new plant than to try to make up for 5 years of obsolescence, which would not be there if you stayed in production and put in small amounts each year to try and maintain them at a competitive edge.

Senator BAUCUS. Could you in some way sort of rank or assign a value to various steps. And by the way I was going to make the same comment that the chairman made; that as the head of a major company you are more than qualified to tell us what you think we should do here. Could you rank reducing the deficit, say $50 or $60 billion in the each of the next 2 years, changing our tax laws however necessary to help make the U.S. cost of capital more competitive, and some kind of intervention in the currency markets? Which do you think is most important? If you could rank them and assign weights, it would help us a little bit.

Mr. **Chandler**. I would sequence them exactly as you have, Senator, in the question. I would put the deficit reduction first. I would put steps to improve America's competitiveness second, and intervention third. And hypothetically, weighing them, I would tend to go 60/30/10.

Senator **Baucus**. Now, deficit reduction of $50 to $60 billion each of the next 2 years has been suggested. Is that about the right amount do you think or would you go further?

Mr. **Chandler**. That is a long way from my base of knowledge. I would simply press as hard as we could to get the maximum reduction. I really could not judge that quantitatively.

Senator **Baucus**. Thank you very much.

Mr. **Chandler**. Thank you.

The **Chairman**. Senator Bentsen?

Senator **Bentsen**. Mr. Chandler, you are an impressive witness, and I am glad to hear your comments because you represent a company that has been out on the edge of technology in your industry, and it is a growth industry. Having these kinds of concerns and problems with the disparity of the dollar as compared to other currencies is of concern to me.

The chairman backed off from a question, but I am not going to back off because I was thinking about it as he said it.

When I was chairman of the Joint Economic Committee, we brought out a recommendation to encourage capital formation, savings, and modernization of the productive capacity of the country. And what the administration proposed in 1981 went along those lines, and I voted for it. Now, I am looking at something that seems to be 180 degrees the other way, and I am having trouble changing my mind as fast as they seem to have. We are a society that has a great propensity for consumption, as opposed to Japan. It seems to me that we have a tax bill proposed to us that is going to further encourage that, and I don't see the encouragement of capital formation. I see a reversal of the cash flow that was available through the ACRS for the kinds of incremental modernizations you are talking about, much less building a new plant. Would you help me to make up my mind?

Mr. **Chandler**. In my opinion, the most serious challenge the chief executive of a major corporation has is capital formation. The generation of cash flow to replace and modernize plants is the key to the future of the company, and in the past recent years if you look at what has happened to American corporations, they have moved in the direction of funding largely by debt—maybe I should say largely—in large measure by debt and debt financing is borrowing from the future, and while it is better than no capital formation, it is not the best. It seems to me that from America's worldwide competitiveness as a nation, America gets its money back many times over when it is spent on capital formation. That it is in the interest of this country to form capital because that first produces jobs to put the capital in place. Second, it produces jobs to operate the capital, and those jobs generate earnings that the—the goods that come out of the capital generate earnings at the corporate level, and to me it is unthinkable to tax the process that generates capital because that capital pays off this country two or three times back. And it is a very critical part of the lifeblood of a company.

Senator **Bentsen**. I think I understand that answer. Thank you very much.

Mr. **Chandler**. Thank you.

The **Chairman**. Senator Long?

Senator **Long**. We are looking forward to one, when its full effect is felt in 1990 that is expected to put $45 billion of additional taxes on business. Some of the big items are the elimination of the investment tax credit, the ACRS, and capital gains. And that, of course, will help finance an 8-percent cut in individual taxes. Is that going to help with this problem of the deindustrialization of America?

Mr. **Chandler**. Mr. Long, if it would also perhaps make it attractive for people to invest in equity in a company and not be taxed on the dividends, it would be very helpful. I think it also would be helpful on the face of it without that caviat if the maximum tax rate for corporations is reduced and if the tax plan is more equitable among companies. At least then, the competition within this country, which is a different subject from what I was addressing this morning, the competition within this country is more equitable due to the tax structure—that would be favorable.

Senator **Long**. I am just looking at the figures. There is a $45 billion tax increase on business, and although it is true that the businesses would get a lower rate, but by the time you get through adding it all up, business in general is paying $45 billion more. Now, my impression is that those who are going to benefit most from that rate cut are people like those in the grocery business, not necessarily those in the manufacturing industry. Have you analyzed the President's tax plan to see how you would come out as far as the manufacturing business is concerned?

Mr. **Chandler**. Our effective tax rate is close to the statutory level, I believe, and if hypothetically, the tax rate were lowered to 35 percent, we would benefit as a corporation. Therefore, I think that you could say that strong profitable, multinational corporations that are paying at the statutory level on taxes—the upper limit—are going to benefit.

Senator **Long**. Do you think that that would offset the loss of the investment tax credit and the ACRS?

Mr. **Chandler**. They are close to a wash. Yes.

Senator **Long**. Thank you.

The **Chairman**. Senator Danforth?

Senator **Danforth**. Mr. Chandler, you are not an economist, I am not an economist. I don't know what to do about the problem of the value of the dollar. Let me see if you agree with my hypothesis. My hypothesis is that something has to be done about it.

Mr. **Chandler**. I agree.

Senator **Danforth**. That is to say that while we are not clear as to what the answer is, we all hope that the answer is getting the budget deficit under control and that we will succeed in getting the budget deficit under control. If that doesn't work, then we are going to have to find something that does work, but one way or another we have to get the value of the dollar to a reasonable level so that it doesn't operate as a 25- to 50-percent tariff against American exports and conversely a subsidy for foreign imports. Are we on the same wavelength?

Mr. **Chandler**. Yes, we are.

Senator **Danforth**. Now, one official of the administration said privately a week or two ago that the problem of the dollar is taking care of itself, and he had reference to the fact that the dollar has been declining over the last few weeks and presumably because of the savings and loan associations in Ohic, or some other reason. And he was very relaxed and casual in saying that this is a problem that is taking care of itself. Do you think that it is taking care of itself?

Mr. **Chandler**. No, I do not. I think we have had prior occasions in which there have been some temporary interruptions in this upward side, but there has not been anything fundamentally changed at this point.

Senator **Danforth**. So, the fact that the dollar has been going down in recent weeks—I mean, we are glad it has, but it is not the kind of thing that should lead us in the Government to relax our concern.

Mr. **Chandler**. If the dollar stayed for the rest of this year right where it was yesterday, our incremental effect in 1985 on earnings would be at least half what it was in 1984.

Senator **Danforth**. Now, this committee deals with trade policy, and we have long debates and discussions in the committee on what to do about trade policy and how to handle unfair trade practices of the Japanese and what to do about trade with Mexico and so on and so forth. Those are very interesting issues, but am I correct in my thought that even if we had the soundest, the best conceived, and the best operated trade policy, if we don't address the problem of the value of the dollar, we are simply not going to be able to compete on international markets? That this is the sine qua non of fixing the trade problem?

Mr. **Chandler**. I believe that, yes. I used the number of a cumulative 15 percent per year price effect that we have lived with for 4 years in our company, and that means—take a country like West Germany where we market products that a Japanese manufacturer can be 50 percent below us in price. An American company really does not compete effectively in that circumstance. It is a life or death situation as far as we are concerned.

Senator **Danforth**. Let's suppose that we do get the budget under control and we are able to reduce it, maybe even below 2 percent—deficit 2 percent of gross national product, and it turns out that it has a perverse effect. Some people are suggesting that—that it makes our economy seem even more sound and more of a safe haven and that the value of the dollar goes up, not down, as a result of that. Do you think that we should then be considering other things to do about the value of the dollar?

Mr. **CHANDLER**. That is a good point, and I think that that is reason enough to give serious consideration to the experts on intervention and to have a parallel program under consideration there. I personally do not know what I would recommend, but I know there are people that have some good thoughts on that, and they are sitting in the row behind me.

Senator **DANFORTH**. Great. I am in total agreement with you that this is not the time to come forward with some unusual scheme to redress the problem of the dollar, that the best medicine is the natural medicine of getting the budget deficit under control, but you darned well better have your team of experts there in the wings waiting to suggest whatever the next best approach is.

Mr. **CHANDLER**. I believe that is right, and it is long term and short term. In the long term, these fundamentals like reducing the deficit are the correct direction to go in our opinion. For short term we may need intervention.

Senator **DANFORTH**. Thank you, sir.

Mr. **CHANDLER**. Thank you.

The **CHAIRMAN**. Senator Grassley?

Senator **GRASSLEY**. I got in a little bit late, Mr. Chairman, so I don't know whether I ought to take the time of the committee. I would like to put a statement in the record and I guess I would like to emphasize that unless we do something about the budget deficit, all these other things are going to remain big "if's" and we ought to get that out of the way as a No. 1 priority. The other thing I would like to suggest to the committee is that if you read the history—and this isn't in my statement, but if you read the history—of the 1960's when the Williams Committee came on the scene, the think-tank approach, task forces of Government people, industry people, and union people, business leaders, and we were going through some of these very same problems then. And, I think maybe since we do have a lot of these unknown questions, and we don't know whether the budget deficit is going to take care of itself, we ought to think in terms of some high-level approach of experts on this subject to look at it again so that we aren't 1 or 2 years down the road if we do get the budget deficit under control, still holding hearings like these facing these questions. And I would suggest that for consideration on the part of the committee and particularly the chairman and any of the witnesses that are here today.

The **CHAIRMAN**. A point well taken. Are there other questions of the witness?

[No response]

The **CHAIRMAN**. If not, Mr. Chandler, let me simply say if you are at all typical of your profession, I would welcome other chemists to testify at length. You are an excellent, excellent witness, and your statement was superb.

Mr. **CHANDLER**. Thank you, Mr. Chairman.

Senator **MOYNIHAN**. It is not his profession—it is the weather in Monroe County. You tend to activities of the mind—there is not much else to do. [Laughter.]

The **CHAIRMAN**. Thank you very much for your excellent testimony.

Mr. **Chandler**. Thank you. You have been a very gracious committee. Thank you very much.

The **Chairman**. Next, we will take Mr. Robert Roosa from Brown Brothers Harriman & Co., a man whose reputation and presence is well known to this committee.

STATEMENT OF ROBERT V. ROOSA, PARTNER, BROWN BROTHERS, HARRIMAN & CO., NEW YORK, NY

Mr. **Roosa**. Thank you very much, Mr. Chairman, for this opportunity. I was abroad when the invitation arrived, and I got your permission to submit a statement rather late in the game, and the full statement is about ready to be typed and will be submitted as soon as I can get home and have that done tomorrow. Meanwhile, I have provided an excerpt, and I will summarize that very briefly. I think we start off with the benefit of an incredibly useful analysis that has come from the members of this committee, and I don't have to repeat, except to confirm, my own agreement with the feeling that the floating exchange rate system as we now have it, and the benign neglect the administration up to now has displayed with respect to it, is leading us on a course implied by your own question, Mr. Chairman, that it does actually mean that we can never achieve the free and open market trading system toward U.S. policy has actually been directed ever since World War II and for which the GATT was designed.

We are going backward, more into protectionism, more into barter and countertrade, more into the export of jobs. We are getting, as some of you have said, a deindustrialization. We might even call it the depopulating of the agricultural sector. All of these are consequences of an overvalued dollar, and to refuse to call it overvalued is semantics—on the part of this administration. It is overvalued in relation to any relationship as to the goods prices, the services prices, the productivity or the performance of countries that are engaged in trade with this country or around the world. And the difference has arisen, as several of you have made so clear, because of the fact that in the well-integrated, highly sophisticated capital markets of this modern world, capital movements in response to any whim or change of sentiment can so dominate the actual going exchange rate that the going rate will be far different from what the fundamental exchange relationship among prices would otherwise be. We have developed an enormous gap, and, therefore, the problem to deal with is how to bring the actual market rates closer to the purchasing power relationships which used to dominate before the significance of capital movements was so great.

Now, of course, we have always had some distortion introduced by capital movements, and that isn't altogether new. It is simply that the scale is now so great that we have to take a fresh look. Consequently, I think we first of all have to commit ourselves again to the fundamental American proposition that we believe in free and open markets, both for trade and for capital, and, therefore, the solution is not capital controls—although I was a transgressor myself. Senator Long will remember when I invented the interest equalization tax, among other things, and John Leddy helped put it through—but I learned my lesson. I don't think capital controls of that kind, even though the Japanese are now considering them, are appropriate. Instead, we have to find ways in which we can exercise or introduce coordinated countermeasures, and I view that not just as intervention in the foreign exchange markets, but in a much broader sense. And to that end, I have made three suggestions.

The first is that the five countries whose currencies represent the IMF's SDR, the same five who very often meet as the "Group of Five," should take a further step beyond this casual and informal contact that occurs among finance ministers and central bank governors from year to year and become a formally organized center on exchange rates, under the surveillance of the IMF. The Center should aim at doing two things: first, continually appraising the direction of change that would be appropriate to bring the going exchange rates closer to the fundamental relationships then existing among these five countries. They account for so much of world trade and they represent so much of the foreign exchange activity of the world that the worldwide influence would be great if we got these five coordinating their efforts on the basis of the frank appraisal of what direction or what zone is appropriate in getting exchange rates back toward the fundamentals in the underlying price and performance relations among these major countries. After that, second, they have to concert an action program, and a major part of that action program today would start, of course, with getting the U.S. deficit down. But I don't agree with the implication that some have given here that getting the deficit down is enough. As a matter of fact, it is a good first step. There is a second step which I would introduce immediately, and Scott Pardee will tell you all about it, and that is for the United States to begin purchasing very heavy amounts of the major foreign currencies in this group. Not only will that help edge the dollar down, but it will provide the Government with a sufficient reserve supply of currency so that in the event things turn around and the dollar begins to plummet, you do have an available reserve of currencies to use to cushion the decline. That, Mr. Chairman, is the essence of what I want to propose, and I will be glad to discuss it as opportunity affords with the questions that arise in your minds.

[Mr. Roosa's prepared statement follows:]

PREPARED STATEMENT OF ROBERT V. ROOSA, PARTNER, BROWN BROTHERS HARRIMAN & CO.

STABILIZING THE EXCHANGE OF LEADING CURRENCIES

Mr. Chairman, it is again a privilege to appear before this Committee. Your invitation comes as a nice coincidence. For only two weeks ago, Secretary Baker, in the spirit of a new Treasury team taking a fresh look at the world's trading and monetary system, was in Paris indicating a readiness to probe for further promising lines of international cooperation. And exactly twenty-four years ago this same month, in the same city and at the same organization, I was in Paris as Under Secretary for Monetary Affairs in a new Treasury team, making similar suggestions in the context of those times.

To be sure, the times have certainly changed, but the fundamental aims remain the same—to maintain conditions for the world system as a whole in which trade and payments among countries will normally reflect the prices, productivity, and performance of each, in which incipient individual deviations from the norm become self-correcting, and in which (as a result) growth with stability will be promoted everywhere. Your statement in calling these hearings, Mr. Chairman, succinctly identifies the impairment of those aims today, as manifested most glaringly in the mammoth U.S. deficits on trade and current account, and in the paradoxically high value of the dollar against other leading currencies. Indeed, the logic of all past experience with the "adjustment process" has been turned around. Determination of the dollar's exchange rate with other currencies has for the past several years been detached from the fundamentals.

If purchasing power parity, and the relative performance of individual economies were still paramount determinants, the D-mark/dollar exchange rate would surely be closer to two than to three; the yen/dollar, closer to 200 than to 250; and the pound sterling, closer to $1.75 than to $1.25. Nor would there be such wide oscillations among these rates which have sometimes approached 10 percent within a single week.

In my own view, this same floating exchange rate system can, with appropriate U.S. involvement alongside other leading countries in exerting direct concern over these exchange rates, become a reliable payments environment capable of supporting a viable international trading system. That is why I was delighted while in Europe to read of Secretary Baker's offer to host a meeting to consider improvements in the working of the world monetary system, and I heartily endorse his suggestions that that focus should be on the convergence of economic policies, on assuring exchange rate stability and on the need for fuller IMF surveillance of the countries' economic performance (Financial Times, April 13, p.1). Before briefly mentioning my three principal suggestions for innovation in the U.S. participation in the international monetary system, I should note my own conviction that the floating system as it now operates will make survival of the GATT concept impossible. Indeed, intensifying uncertainties and erratic behavior of exchange rates will drive more and more trade into mercantilist patterns.

With respect to the monetary system, my first suggestion is for a modest forward step in organized relations among the leading countries. My second concerns the methodology and content of a new action program. My third concerns the orientation of U.S. economic policy, within the framework of the two preceding proposals.

(1) *Organized relations among the leading countries.*—The five countries whose currencies determine the value of the IMF's countries whose currencies determine the value of the IMF's Special Drawing Rights must collectively take their international obligations more seriously, and work more closely together, if there is to be reasonable hope for meaningful stabilization among their exchange rates and thus for most other currencies. This does not simply mean reaching agreement on coordinated central bank intervention in the foreign exchange markets. Much as that is to be desired, it would fall far short of the real objectives unless intervention, when and if appropriate, were reinforced by synchronized action in the domestic monetary and fiscal policies of each country. And in markets often dominated by capital flows, even reinforcement through putting each domestic house in order would not be enough; it must be supplemented by action influencing capital flows. For until the exchange rates resulting from capital transactions can come close to the underlying relations among the prices and performance of the five countries, distortions as grotesque as those of 1984 and today will still occur.

This does not mean direct control of any kind over capital movements. Instead opportunities must be found to rely on the forces of the market—through interest rates, or through governmental borrowing of other currencies, or governmental purchasing of other currencies—to bring about countermovements that may offset capital flows which would otherwise pull the prevailing exchange rates away from the underlying real relationships.

(2) *Defining the benchmarks for alternative action programs.*—Whether labeled as "target zones" or "equilibrating range", or an "equalizing range", or an "optimal range", or merely as a "frame of reference"—some identifying guideline is needed to give an understandable focus to any negotiations that aim for stability in the exchange rates among the leading countries. The real purpose of negotiations, which begin by agreeing on the "zone" or "direction of change" that is suitable for the exchange rates among the key currencies, is to use the negotiations concerning appropriate corrective action a usable benchmark. Once there is agreement that market rates should be heading toward some range or zone in which they would more nearly balance the underlying price and performance relations among the key countries, then the operational negotiation can really begin. The negotiators will have to agree on appraising the forces that produce the existing disjunction or gap between the going market rates and the real rates underneath, and then proceed to consider the actions which each participating country could take to help reduce that gap. The negotiation will involve appraising the comparative degrees of sacrifice or

compromise to be accommodated in making reasonable tradeoffs as to monetary policy, fiscal policy, or the purchase or borrowing of each other's currencies.

An established consultative framework in which the exchange rates, and influences bearing upon them, were under frequent periodic review, would have two kinds of advantages. One would be to crystalize recognition of those influences of greatest significance for moving all five economies toward a harmonized convergence. The other would be that such continuous appraisal would preclude any fixation on rigid conditions or formulae so that there would be enough "flex" in the exchange rates to accommodate significant changes in comparative advantage among the five economies. All aspects of this new approach should be developed in conjunction with the management of the International Monetary Fund and remain continually under IMF surveillance.

(3) *The orientation of U.S. economic policy.*—I have just returned from extensive travels and contacts in Europe with two arresting views. One is that much of the financial world is literally holding its breath. Trade and current account deficits of our size, it is said, are so abnormal by any standard that they simply must end soon and possibly with that ending will come a plummeting downward of the dollar. The second clear impression, as stated pungently by an official of the European Economic Community, is that Europe is ready and eager to participate in any proposal for joint corrective or defensive action that the U.S. may propose. He did add that we should not count on Europe unless Japan also joins in any cooperative effort; but a former senior Japanese official who overheard the comment assured me that Japan was at least as ready as Europe to join in a mutual effort. The time is clearly ripe for the new Treasury team to take the lead—a lead in cooperation, not domination.

As a first effective demonstration of a new U.S. commitment to help reduce the instability of the floating rate system, the Treasury should authorize the Federal Reserve to expand the government's holdings of foreign currencies. The total could well rise from the present $8 billion (equivalent) to $50 billion (equivalent) or more through steady purchasing in the market, thereby gradually easing the dollar exchange rate down. Any unwanted side effects on the U.S. money supply could readily be sterilized through techniques as old as the Tripartite Monetary Agreement of 1937. And the announced intention gradually to acquire DM, yen, or other leading currencies, could help strengthen those currencies by offsetting any current inflows from those currencies into the dollar.

To be sure, the effect of expectations could be to make foreign holders of dollars wary. But to counter the risk of any sudden run out of dollars, the Federal Reserve would have its newly acquired holdings to use to staunch a run. Moreover, it would also have access to $25 billion (equivalent) or more through drawings on the existing swap lines.

There is still more than the U.S. can do in other sectors of vulnerability for the international monetary system. As Secretary Shultz said so clearly at Princeton a few days ago, decisive action to reduce our own domestic deficit could lead to further declines in our own interest rates. Lessening the spread of our interest rates above others may further reduce capital inflows, and perhaps even spur a revival of some capital outflows from the United States. Any move toward more realistic dollar rates can surely help turn the pattern of our external deficits in a more favorable direction.

Lower dollar interest rates could help, too, by reducing the debt burden of many of the developing countries. There could be further help for the Latin American countries, most of whom peg their currencies on the dollar and have thus been crowded out of some U.S. markets by competitors from Europe or Japan whose currencies and prices have gained so much competitively from the overvalued dollar.

Perhaps I should be so daring as to suggest that the U.S. has its foreign policy priorities wrong in this hemisphere. Nicaragua may be an important token for resistance to potential Communist infiltration. But Brazil or Argentina or Mexico, or a dozen other countries in this hemisphere are still precariously balanced as to their survival as free enterprise economies. They need much more explicit U.S. support. Our trade policies and our participation and contribution to the IMF and IBRD need an orientation centered on the study revival of genuine private enterprise economies throughout this hemisphere.

So even in advance of Secretary Baker's meeting, but as an earnest of the intention to move the U.S. back to the center of the concern shared for so long by our allies, there is scope for decisive action. None of the exchange rate rigidities of the old gold standard can ever be revived as the route back toward stability; the moving parts of the world economy are too diverse for that now. We will have to live with floating rates. But such rates can, by reflecting the fundamentals of the real market forces in the prices and productivity of each leading country, be managed discreetly and jointly in the common interest of the world economy. I hope the Committee will urge the Treasury to embark on such a course.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. Mr. Chairman, thank you. Mr. Roosa, you suggest that the G-5 basically use their trade relationships and balances as a method of trying to figure out what is the right value of the dollar and the other currencies. Is that practical, taking into account capital flows, not just trade flows?

Mr. ROOSA. Yes, I think it is practical. As a matter of fact, in their own discussions, and of course, I don't sit in on them now, but this goes back even to my day, these questions are discussed, and there is no question on the part of any of the four—exempting our own Treasury—that the dollar is overvalued because of the impact of capital flows and that, therefore, first of all a directional change in exchange rates is appropriate. Whether or not they would ever agree on how far it should go, all would agree that something ought to start and ought to keep moving from the level we have now reached, even with the current modest decline.

And then second, when it comes tc implementing this, there are various things that can be done. Now, I have talked with Prime Minister Nakasone about this. And there are two ways of doing it. I mentioned that on the one side we buy foreign currencies. On the other side, they can borrow dollars and then use them to buy yen. They have done it once for $100 million. They now have the authority through their own Diet to do this on a larger scale. They haven't done it because it is futile to do it unless it is part of a coordinated program and unless it is something in which all five of the major countries agree they are pursuing the appropriate course. Now, as far as this is concerned, you are saying: Is it practical? Of course, in anything that involves international agreement, there is going to be all kinds of slippage. The important thing is to get a momentum going.

Senator HEINZ. You mention, and it is most encouraging that you do so, that Japan would be willing to participate in some kind of corrective or defensive action here.

Mr. ROOSA. Yes.

Senator HEINZ. Would you say that over the last 2 to 3 years that Japan has made every effort to internationalize their currency, the yen, or have they been somewhat reluctant to do so?

Mr. ROSSA. They have been slow, but it is a very odd paradox, that in responding mainly to our pressure, but partly from that in Europe, in 1982 they decided that they would begin to unfreeze the constraints of their own market on the export of capital. Now, the odd result of that is that in 1983 they had such a large outflow of capital that, of course, it reduced the value of the yen. It kept driving it down. In 1984, the export of capital was even larger, roughly, the overall figure net is something like $35 to $37 billion equivalent. And that is a major factor.

Senator HEINZ. Should we be surprised about that?

Mr. ROOSA. No.

Senator HEINZ. I don't mean we should be surprised when a country that has large trade surpluses exports capital. That is almost inevitable.

Mr. ROOSA. Absolutely.

Senator **Heinz**. Those kinds of relationships can only be changed over time.

Mr. **Roosa**. Oh, yes.

Senator **Heinz**. When direct investment takes place in the Japanese economy, it changes, to a certain extent, the structure of their economy. Let me just ask you this because my time is about to expire. You have suggested a hedging of currencies in effect. Is there some way of guarding against some of the side effects of our purchases and holding of these various currencies? Are there any methods of sterilizing them?

Mr. **Roosa**. Oh, yes, indeed. I cut my teeth on that in the tripartite monetary agreement of 1937, and I only joined the Federal Reserve Bank after that was being unwound, but the technique is there and it can be done.

Senator **Heinz**. Last question. Has the dollar's value peaked and/or has it bottomed?

Mr. **Roosa**. I have made this mistake before, so I had better be careful. I hope that it has peaked and that the present oscillation is something that may be eventually succeeded by further decline, but I think it is a continuous judgment that occurs in the marketplace itself. I recognize the point made earlier that it is possible if we do get a major reduction in our own domestic budget deficit, and it is on a trajectory that looks as though we are genuinely going further and further down, this may so reenthuse the foreign investor—he may think, by golly, the United States is finally back on a sound track—that it may move us in the other direction, and capital may begin to flow in again. So, I don't rule out that possibility, but then I say we must be dealing with the capital flows. And there are ways in which, through coordinated action, that can be done.

Senator **Heinz**. Thank you.

The **Chairman**. Senator Moynihan?

Senator **Moynihan**. Mr. Secretary, I want to ask you about that tripartite monetary agreement of 1937. That is durability, sir. Could you tell us more about the proposal to increase the Federal Reserve's holdings of foreign currency from $8 billion to $50 billion? How do you do that? And may I say, in that context, are you thinking here not just of the question of the dollar going up, but the possibility of the dollar collapsing?

Mr. **Roosa**. Oh, yes. Covering both sides.

Senator **Moynihan**. Yes.

Mr. **Roosa**. The initial effect of announcing a program without indicating day by day how much you are spending, of using Federal Reserve funds to buy foreign currencies, it is just the same thing we do in using the swap line except that you buy them outright instead of having a temporary cross-holding of currencies. And it is possible that the counterpart of that would create more dollar liquidity inside this market than is consistent with Federal Reserve policy, and the normal way of sterilizing or neutralizing that is through offsetting domestic open market operations, which is something that the trading desk of the Fed of New York is equipped to do. I established the system for following that in 1953, and they still use the same measures and the same way of being able to guage and offset is there for use any day.

Now, in terms of the total amount, the stabilization fund isn't big enough. It isn't likely to swell enough so that the Treasury could hold a large part of this. It has to be a Federal Reserve holding. Nonetheless, the use of any such balances under our laws and Constitution can be exercised by the Fed only with the Treasury's permission, or with the Treasury's guidance. So, it becomes a genuine Government operation. And as far as the other side of this is concerned, we could get to a point where the dollar begins—or gives evidence of beginning to plummet—an actual run develops because that breaking point has been reached with the rest of the world knowing, as several of you have mentioned, that this is an intolerable situation, that it simply cannot go on forever, and eventually you reach the breaking point and money begins to run and runs to D-mark or the Swiss franc or the yen or even French franc or sterling. In that event, then having a substantial reserve stockpile makes it possible to feed that back into the market, and of course—this is only incidental—you make a lot of money on that. The swing in the currency—we used to do that when I was in the Treasury. We built up the stabilization fund that way, but that wasn't the purpose, but it just happened to be a nice byproduct.

Senator **Moynihan**. Is this something that we must do by legislation or is this something where a decision can be made between the Treasury and the Federal Reserve?

Mr. **Roosa**. Treasury can make that decision

Senator **Moynihan**. Thank you very much.

The **Chairman**. Senator Baucus?

Senator **Baucus**. Thank you, Mr. Chairman. Mr. Roosa, as I understand your basic point, it is that the dollar's value has not become detached from basic fundamentals. You state that some coordinated intervention by the five major countries would somehow help here. I am still unclear about something. That is, why do you think capital flows become so independent of trade flows?

Mr. **Roosa**. First of all, there is always in a world where there are opportunities for the free movement of capital opportunities to take a speculative run when you see a situation that you think is going to improve. If the currency seems to have been rising, there will be some marginal—oh, it is much more fundamental than that. This is only the beginning, but what fundamentally has happened is—well, there are actually at least five reasons for the flow, but the condition that enables it is that under the inspiration of very creative banking practice in American leading banks and those abroad, the international capital markets around the world now for at least the last 4 or 5 years have become so much more efficient in the capability of handling enormous volumes of——

Senator **Baucus**. But why has that greater efficiency resulted in an overvalued U.S. dollar?

Mr. **Roosa**. Because in this period five factors were at work. One we have already mentioned—the big interest spread, and we know that interest rates have been——

Senator **Baucus**. There seems to be agreement on that. Number one is the interest spread.

Mr. **Roosa**. And that is partly related to our big Government deficit. No. 2 is the usual safe haven consideration, that with the world in turmoil there are people who just feel this is a safer place to be. A third is the attraction of the American business performance as it emerged following the recession of 1981-82, which also became a significant attraction. A fourth is simply that, because the dollar in a world where trade has begun to improve where the dollar is the major vehicle currency for the conducting of trade, it becomes useful to begin accumulating dollars, dollar balances, the earnings on dollars, simply as part of the working capital for financing a growing volume of trade. And then, the fifth is the speculation that I mentioned.

Senator BAUCUS. All right. Now as to the fourth, it would seem to me that once businesses and nations has accumulated enough dollars for the transaction of trade, then inevitably currency values would start more accurately to reflect fundamentals so that should take care of itself.

Mr. ROOSA. Yes. That should help.

Senator BAUCUS. That part should self-correct. What I hear you saying is that the basic solution, therefore, is the more fundamental one that Mr. Chandler suggested: reducing the deficit and getting interest rates—real rates—down. We hope we will always have a safe haven here, though.

Mr. ROOSA. Yes, yes.

Senator BAUCUS. We don't want to do much about that.

Mr. ROOSA. We certainly don't.

Senator BAUCUS. So, of the five causes that you listed, the only one that we can attack it seems to me, is high interest rates, through reducing the deficit. But you seem to be saying in addition that we need some coordinated action by the five major countries.

Mr. ROOSA. Yes, because given the almost quiveringly sensitive movement of funds in the international markets now, as long as the United States from time to time has these unique attractions, there will be flows here, but don't misunderstand me—3 or 4 years from now the flows may be the other way. Remember 1978, the dollar was weak. And that can happen again. I am just saying that in this world of floating rates, we really will benefit—the whole world will benefit—if there can be a more coordinated approach taken by the five responsible countries.

Senator BAUCUS. I have some trouble imagining successful use of the coordinated approach because in times of nationalism it is difficult for individual countries to think in the longer term of the world's best interest. That is, they think in the short term. A system of fixed exchange rates would force governments to impose the necessary fiscal and monetary discipline to keep the country's economic house in order. Governments don't like fixed rates because the system tends to require a discipline which governments prefer to avoid.

Mr. ROOSA. Surely.

Senator BAUCUS. That is one reason we have this problem. Governments like to go onto flexible rates, because such a system masks underlying problems when different countries in different parts of the world have different economic policies. Add to that the free flow of capital—and capital goes to those countries where there is a better rate of return—and the situation is magnified. I think we are living now on borrowed time in the United States with these big budget deficits.

Mr. **Roosa**. Sure.

Senator **Baucus**. So, I am just wondering if it might make some sense to go back, if not to fixed rates, to something closer to fixed rates than today.

Mr. **Roosa**. You see, that should be the end result of the approach that I am suggesting.

Yes, as these five, or it may well start out with only three for that matter—the Japanese, Germans, and the United States. As long as they recognize in each case, this isn't just altruism. This is to protect each country's position——

Senator **Baucus**. I appreciate that, and I agree with you. My time is up. I just don't know how much confidence I have in other countries. Thank you.

Mr. **Roosa**. Right. Thank you.

The Chairman. Senator Long? I apologize, Russell, Lloyd is next, I'm sorry. Senator Bentsen?

Senator **Bentsen**. Mr. Roosa, I will go ahead because I want to further explore what Senator Baucus was talking about. You have capital flows now that are estimated all the way from $30 trillion to $50 trillion through the financial markets, which dwarf the trade flows that are estimated at around $2 trillion. That means currency transactions are maybe 20 or 25 times as much as goods transactions worldwide. Prior to World War II, you saw floating rates somewhat discredited because of the very nature of the fluctuations in rates, and you also had substantial capital flows. Today you are seeing a situation of this rising protectionism at about the same time as these currency and trade distortions. Certainly, I agree that we don't want to go back to the excessive rigidity of Bretton Woods, but we certainly want to get away from the excessive gyrations that we see today.

Mr. **Roosa**. Absolutely. Yes.

Senator **Bentsen**. And you made a recommendation. I would like to give my time to you to further explore the feasibility of these countries working in concert to accomplish a reduction of these gyrations. So, would you further elaborate your views?

Mr. **Roosa**. Yes. Of course, the proof will be in the testing, but in my view, the urge is evident in the way in which they, at all the summits of all seven countries, repeat every year their commitment to getting a convergence of economic policy, but nobody really does anything about it. What we need is something that is more formally and regularly organized in which the subject is how do each of these three or five participating countries begin criticism and consultation among themselves to determine what are the major courses of action which can lead to this convergence. And what that is going to mean, of course, is the first time they sit down they are going to tell us to cut the U.S. deficit, but let's hope that can already be underway. But then, beyond that——

Senator **Bentsen**. Would you repeat that?

Mr. **Roosa**. I said the first time the group were to sit down if one of the conclusions would be that a source of the imbalance comes from the U.S. domestic deficit, and therefore, one of the conclusions of such a negotiation would be that first of all the dollar is too high. The other rates should begin to come up, the dollar should come down, or the direction it should be in. But one step is the U.S.

deficit should come down. This, of course, they say now, but it doesn't have the same force or effect—certainly not on our own Treasury—unless we are already in a much more systematic and sustained relationship which has the sort of further validation that it is known to the world that this is where the key countries are accepting their own responsibility at the same time advantaging themselves in the only way that is possible because we can't go back to a fixed rate system.

I have used—I guess I was the first to invent—a phrase that everybody treats derisively—target zones. I started that in Japan over 10 years ago. Now, the trouble is that people think that target zones only mean intervention by central banks at the margin. That is a useful thing, but that is not enough. My concept is if you can get agreement on what the target zone is, start with what the direction of change ought to be, then eventually what the zone is, this becomes a discipline that Senator Baucus was mentioning that at least has some relationship to what we used to get from the discipline of the gold standard. It will signal to the participating countries what are the major domestic policy moves that they ought to be considering in order to make the system and themselves, for the longer term, enjoy the benefit of a more nearly stable exchange rate system. Now, the second thing, apart from this, there will be the occasion for what Chairman Volcker has called coordinated market intervention, and that, too, we have a swap line we can draw currencies for, but if we have a big stockpile of currencies that makes it even easier, we can then have intervention. And you will hear from Scott Pardee and others who have real trading experience that it is possible to smooth out these 5- and 10-percent wild gyrations that now also add to the uncertainty in ways that I think impair the growth of trade, for us and for others.

The Chairman. Senator Long?

Senator Long. I gain the impression that you did not feel that a reduction of the deficit—and that is all we can hope to do in the foreseeable future—is going to solve this problem of the overvalued dollar. It may help some, but there is a lot more to it than that, and even if we reduce the Federal budget deficit by $50 billion, the dollar will still be a very severe problem.

Mr. Roosa. Yes. Yes.

Senator Long. Now, I happen to think that that is a safe prediction. I think that you are correct in that, in terms of what we can hope to do. Let me just tell you from what I hear from talking to Democrats and Republicans and seeing what I think we can do, if we do not have a tax increase, we are not going to get this deficit down by any $50 billion. And even that $50 billion figure is predicated on assuming that this expanding economy keeps going the way it has been going, and that, Mr. Roosa, is not a safe assumption, and you know it just as well as I do.

Mr. Roosa. I do, yes.

Senator Long. As a matter of fact, we don't see any real relief in view of a meaningful nature that people like our friend from Kodak here—Mr. Chandler—who testified about the problem his company sees. Now, we obviously need to work for something different than we have here, and I regret to say that usually the Congress doesn't act until something gets desperate. It has got to get horrible to get bad enough so that Congress as a whole will say, my goodness, something has got to happen—let's get going. Where can we turn for leadership? Who has some answers? Let's try to do something. I see you are nodding—you agree with that. That is how it was when you were in Government.

Mr. ROOSA. Sure. Oh, yes.

Senator LONG. Just the fact that it was bad wouldn't get the Congress to act. It would have to get horrible. And at that point, they would say something must happen—let's do something. So, we finally get together and move with something to try to solve the problem.

Mr. ROOSA. Sure.

Senator LONG. Now, what were the five countries that you think might be able to control this situation of these exchange rates? The United States, Japan, and who else?

Mr. ROOSA. Germany.

Senator LONG. Germany, and the U.K. and who else?

Mr. ROOSA. The U.K. and France.

Senator LONG. All right.

Mr. ROOSA. The likelihood of France coming in is not as great. The U.K. is also marginal. The other three, I think—or the other two—I am reasonably sure.

Senator LONG. Now, it seems to me that these countries are learning to like this situation. At first, they thought that it wasn't a good deal for them, but the more they see us closing down our plants and them expanding to take up the slack, the more they like it. I hear from the steel people, for example, that they had mills over in France or in Norway that were not efficient compared to ours, but now those plants are being expanded and reopened while ours are being shut down over here. So, those people are getting to like this thing, and the more Americans move their investments overseas, the more those foreign countries will like this trend. Now, I just have the impression that if we are going to achieve an agreement that is to our advantage, the United States is going to have to lead off with some kind of rather drastic step to get everybody's attention and to compel them to work with us. You will recall that when John Connally was the Secretary of Treasury he started out annoucing a 10-percent surcharge and then tried to work to negotiate from there. Does it occur to you that there might be a need to do something of that sort to try to get the situation under control?

Mr. ROOSA. Yes, and as you know, the President has the authority right now to do that, and he can impose that import duty—the same 10 percent. I have talked to President Ford about that just within the last few weeks, and he reminded me that, of course, he had done it. So, this is certainly a bargaining instrument to use. Now, I hope that it doesn't have to be imposed, but if anybody needs a club in the closet, this is an effective one.

Senator LONG. I have tried to talk to businessmen who are looking at the problem. I find myself asking how long can we keep this up? By the time this year is out, we are going to be the biggest debtor in the world. We are even a bigger debtor than Brazil is, isn't that right?

Mr. ROOSA. Absolutely. Yes.

Senator **Long**. Give it 5 years, and we will be a bigger debtor than all the rest of the world put together.

Mr. **Roosa**. We surely will. Yes.

Senator **Long**. Now, I don't know how long we can go with that kind of thing before the whole house of cards falls in. It seems to me that the answer should be that I don't want to find out. [Laughter.]

I assume that you are thinking somewhat in those terms yourself, Mr. Roosa.

Mr. **Roosa**. Yes, yes.

Senator **Long**. I hope that you will continue to give us your advice and some others will because somebody is going to have to come up with some ideas, and I don't see them coming from the administration, I regret to say.

Mr. **Roosa**. I hope there is a chance, based now on the opening indications that our new Secretary has given, as they realize that they are not really near the edge of a cliff and therefore they had better do something or else. And as that comes through to them and they know that it is not just the domestic budget deficit that has to be dealt with, I think something may come out of this proposal for a new monetary conference, and I hope that the results—by the way, I think that the chairman's formulation of questions for this hearing are about the best I have ever seen. It is a succinct sorting out of what the real issues are, and I think as you acquire a record here in the next couple of days and if the new people at the Treasury will sit down and really think about it, they will find some seeds in here that are worth planting.

Senator **Long**. Thank you so much.

The **Chairman**. Senator Danforth?

Senator **Danforth**. Mr. Roosa, I regret that I was not in the room during your testimony. I was unfortunately called out. I have read your testimony and listened to your answers, your responses that were put to the questions that were put to you. I really think you have made a major contribution to our thinking in this area. You have one sentence in your statement, one clause in your statement, which I think deserves repeating. You say: "I should note my own conviction that the floating system as it now operates will make survival of the GATT concept impossible." That cannot be more strong.

Mr. **Roosa**. No. I intended it to be strong.

Senator **Danforth**. You are not saying that this is just one of a number of problems in a difficult trade situation. You are saying that GATT cannot be made to work as it was intended to work unless the problem of the dollar is somehow solved.

Mr. **Roosa**. Yes. Yes. I am currently chairing a group, and I just got this started about 4 or 5 months ago, to put together everything I can on this whole question of countertrade, the way in which that has had to develop under the pressure of the overvalued dollar. Of course, it started in Eastern Europe because totalitarian countries use it, but now it really is growing. And this, if anything, is the clearest challenge to the GATT system that has emerged, and the fact that it has been spreading in the last 4 or 5 years is itself a very ominous warning.

Senator **Danforth**. Now, other than the three specific suggestions that you made, which I think are very helpful, the second thing that strikes me about your testimony is that we shouldn't be waiting. Is that correct?

Mr. **Roosa**. Yes, it is.

Senator **Danforth**. The thought was let's see if we can get the budget under control and hopefully someday we will pass the budget resolution—maybe, maybe not—and the battle of the budget will go on and maybe that will have an effect on the value of the dollar, but your view is that while we should certainly proceed with the budget, we should begin forthwith to deal with—or to find other methods such as your intervention method of dealing with the problem.

Mr. **Roosa**. Yes. Yes. That is exactly what I feel and would urge.

Senator **Danforth**. And when somebody in the administration said, as he did, within the last week or so, the problem of the dollar is taking care of itself, you would simply disagree with that.

Mr. **Roosa**. I do. Yes.

Senator **Danforth**. I don't know of any other question to ask you at this point, Mr. Roosa, other than to compliment you on your testimony and to say that I think you have certainly focused our attention on this serious problem. Do you have anything else that you would like to add?

Mr. **Roosa**. I would just add that on this notion of the dollar taking care of itself, it is possible that something may happen—and you can conjure up various trigger points to make it occur. When the dollar takes care of itself by actually plummeting because conditions of the whole state of world psychology becomes so upset and disturbed—if we have a wave now of 100 more bank failures in the agricultural sector or even if one of the major international banks were to go to the wall—that kind of thing can then generate enough of the reverse psychology to begin a run against the dollar, and in that situation it is not just correcting itself—it is going to go to another extreme. It pulls it so far the other way that we are just being battered from one side or the other.

Senator **Danforth**. And the mechanism you suggested would protect against that as well.

Mr. **Roosa**. That is the thought.

Senator **Danforth**. Not just the overvaluation but——

Mr. **Roosa**. That is the thought.

Senator **Danforth**. Yes. Thank you, sir.

The **Chairman**. Senator Wallop?

Senator **Wallop**. Thank you, Mr. Chairman. Mr. Roosa, let me just toss out a question because I can't come to grips with the answer, but if dollar flows are indeed detached from trade flows, is it possible that we lost the means to measure trade from the early days of this century, where it was all barrels of wheat and pairs of shoes and automobiles? It seems to me if capital flow is 15 to 20 times the trade flow, can't we assume that there is something we are not measuring? Can all the rest of that be speculation, or is there some intellectual transfer, or something else that is taking place that is not in the traditional measurements?

Mr. **Roosa**. I wouldn't say that we have lost the capacity to measure. I think it is important to realize that these very large figures for capital flows represent what are fundamentally paper transactions. A large part of them will never represent an actual transfer of those funds. When the contract expires, the marginal difference is settled. Those contracts disappear. Some new contracts are written. So, the actual transfer of physical bank deposits or other tangible evidences of currency and exchange is much smaller than the calculated totals of these transactions, the transactions just in a day in the Chicago Mercantile Exchange you know, swamp out the daily figures for world trade. So, it is clear that we are talking about two different kinds of measurement, two different sorts of calculations, but it is also true that in these now highly sophisticated capital markets with money able to move so quickly and on very small margins, and when the predominant drift recently has been toward the United States that you will develop inevitably exchange rates which are out of line with what anybody would try to calculate as, you know, this is a fuzzy concept, but to try to get to what we used to call purchasing power parity. I have done it. I think everybody who will testify here has done it, and you will come up with slightly different figures, but I did at least put my neck out—not very far—in the statement. It is in my full statement, and I think it is in the one that I excerpted. But at least everybody knows that capital movements have now given us a D-mark rate of 3 to the dollar, and we know that the actual goods-to-goods ratio is a lot closer to 2 than to 3.

Senator **Wallop**. I recognize that but something is driving people besides curiosity to make these transactions, and I am just wondering if there isn't something that we are not measuring that is a legitimate measure because purchasing power parity in a world like this doesn't have a hell of a lot of relevance to some sectors of the economy.

Mr. **Roosa**. No, certainly not. And of course, we have had debates in the profession since the beginning of the century, anyway, as to how to measure it and what is relevant in the measurement, but the concept nonetheless has a basic meaning and that is why I indicate—and it is my own suggestion—that we can't try to pick precise rates as aiming points. I talk more in terms of zones of reasonableness that would bear some close relation to the price comparisons.

Senator **Wallop**. To finish, let me ask two questions. The first is how $50 billion in foreign reserves would have any effect on $20 trillion worth of capital flows? And the second one would be if that is a valid measure, what would happen if we measured the trade deficit between Kansas City and New York?

Mr. **Roosa**. Those are two nice questions, but the first is that if that magnitude seems small, the important thing is the evidence that this is going to be done. The participants in the market don't know how much is going to be there every day. They know that it may be going on. This has the effect then of swinging those performers in the market who have been going for the most part all one way, swinging them in parallel with the direction that the intended U.S. purchases are going. And in that sense, it makes perfectly good sense from a profit point of view. They will get in today on a ride up in the yen or the D-mark, which is clearly promised by the fact that the U.S. Government itself will be buying more of them. So, you will get the market itself reinforcing what the officials do, and the magnitude, therefore, can be much greater.

Now, as to the balance of payments among parts of the country, of course, this has challenged the economic analysts forever. And it is partly affected, as perhaps your question implies, by differing conditions in the productive plant or productive capability. New England has been high, been down, gone back up again, and these changes are the sorts of changes in—when I talk here about these things, I talk about prices, about productivity, and about performance. And I think all three have to be gauged, and that is what has to be done if you are trying to calculate what is that flow—the lower it now is as to the Sun Belt part of the country. But nobody can really calculate it, you just have a sense that it is tending that way.

Senator WALLOP. My own observation would be that that might have a similar parity with the world's economy as it is much different now than it was a decade ago.

Mr. ROOSA. Yes. Yes.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you, Mr. Chairman. Mr. Roosa, let me thank you very much for your testimony. I personally found it very helpful, and I would just like to clarify a couple of points. You said, as I understand it, and I apologize for missing the formal part of the presentation, that you believe that the contemplated amount of deficit reduction would be insufficient to see a soft landing of the dollar in the next year or so. Is that correct?

Mr. ROOSA. Yes. I would like to have everything we can get, but it just isn't sufficient.

Senator BRADLEY. Right. So, you don't think that it is enough?

Mr. ROOSA. Yes.

Senator BRADLEY. It would be better from your standpoint if we had a much bigger deficit-reduction package; is that not true?

Mr. ROOSA. Oh, yes.

Senator BRADLEY. You also said that you felt that it was possible for the group of five through a policy of intervention to get the dollar down over a certain period of time. Is that not correct?

Mr. ROOSA. Yes; it is intervention in the broader sense, not merely intervening in the exchange market, but by collaborating in the critical development and influence on each other's internal policies—monetary policy, borrowing policy, externally or internally, and so on.

Senator BRADLEY. So, you would like to see an expansion of the kind of group of 10 central banker meetings where people meet and talk more broadly about macroeconomic policy, monetary fiscal policy?

Mr. ROOSA. Yes, and I suggest here in terms of getting meaningful interaction that the group should be small, and I suggest the logical thing of taking the five who are included in the SDR.

Senator BRADLEY. Now, did you say anything about the advisability of trying to restructure Third World debt?

Mr. ROOSA. No; I didn't get into it in this statement. I do have just a passing—I think I included it in this excerpt—paragraph. I feel that we do have a very serious American concern in this hemisphere that we, of course, have properly supported the IMF approach and, in the case of Mexico, we moved in quickly with U.S. funds on a short-term basis. What I regret is that the administration is spending so much time, good will, effort, and energy on Nicaragua when I think the threat to private enterprise in this hemisphere is still great in Brazil, it is still great in Argentina, and it is certainly great in Chile. We have big problems to take care of, too, and we should be devoting a lot of our own financial expertise in the Government to working toward helpful additional ways in which the United States can bring them along. I don't want to make a frightening analogy but right now, if you just look back, 1981 the place where the international debt world was beginning to crumble was Poland, and it took 1982 before it got to Mexico and then it spread, and you know that story. Right now, Poland is coming back. It is coming back because of a number of things, but one of them is that the Russians—I just visited with the Governor of the Central Bank in Russia about 4 weeks ago—and he did it sort of against his will—but they did provide a lot of marginal assistance, and have kept providing it to Poland, more than he wanted to. And as a banker, he just didn't think they were performing as they should, but the Russians took—of course, it is their zone and they have a different approach, so I don't want to stretch the analogy—but, my golly, the way in which they are bringing all of Eastern Europe back to bankability, and we are just standing by and letting South America——

Senator **Bradley**. So, you are saying that austere IMF conditionality and a U.S. administration that turns its head away from the political repercussions of such austerity is a greater threat to private enterprise than the Sandanistas.

Mr. **Roosa**. It is at least equal, and I don't think we are giving it equal attention.

Senator **Bradley**. I don't want to go down that road. You made the point, and I just wanted to clarify it. But my interest in asking you about the deficit reduction, a willingness to intervene, and the Third World debt problem is this: Do you agree that to the extent that we act on all three of those areas, the action in any one of those areas can be less severe?

Mr. **Roosa**. Yes. Oh, yes. And indeed——

Senator **Bradley**. And the reverse of that as well?

Mr. **Roosa**. Oh, yes.

Senator **Bradley**. Our refusal to act on the dollar or Third World debt puts great pressure on the deficit which we cannot reasonably expect to meet, given the political realities.

Mr. **Roosa**. Yes. Oh, absolutely. Yes.

Senator **Bradley**. Thank you.

The **Chairman**. Are there further questions of Mr. Roosa? Senator Baucus?

Senator **Baucus**. One quick one. Mr. Roosa, what would Japan do if the shoe were on the other foot?

Mr. **Roosa**. That is a hard one.

Senator **Baucus**. Just your best guess.

Mr. **Roosa**. My best guess is that they would, assuming now that they were in a position being in a serious deficit—and they were for a long time. They would do what happened to me when I was in the Treasury and they came to me, and I know what they did.

They just simply adopted an IMF-type restraint program in order to bring themselves back around. What they did—and I am trying to remember—I think they had little recessions even before I was in the Treasury, sort of around 1954, maybe 1957, 1960-61—every time one of these things came and they were slipping, they actually reduced domestic spending. They held taxes steady, and they, oddly enough, increased their central bank discount rate. And every time it produced the right recovery. I am not saying that formula would always work, but it is clear from that sequence that the Japanese when they are slipping behind are prepared to take internal disciplinary action of a more effective kind, perhaps because of the way their political structure works, than we seem to be able to do.

Senator BAUCUS. The point is that Japan wouldn't let this thing slide.

Mr. ROOSA. They wouldn't. No.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you, Mr. Chairman. Just one quick question. What do you say to those people who claim that it is impossible for the United States or even the group of five to selectively intervene to get the value of the dollar down? Who say that——

Mr. ROOSA. The magnitudes are too big?

Senator BRADLEY. Yes; it is going to be a 2- or 3-day phenomenon. You have got all this Eurocurrency money. It is going to be speculating against you, and you will not be able to sustain the effort over time.

Mr. ROOSA. Yes. I think the answer, to be a little glib about it, is that no intervention as such is going to be enough. It has to be supported by reinforcing action. Now, in the case of these three or five countries, there would have to be evidence that the United States really was moving on its domestic deficit. There would undoubtedly have to be evidence that as far as Germany and Japan are concerned that they are both aggressively moving to develop domestic consumption of domestically produced products, instead of imported products. As you know, the Japanese savings rate is at 18 percent, the German at 12, ours at 6. You have quite a disparity to try to close, and in each case they would be pressing us to impinge more on consumption as far as the impact of our taxes are concerned, and we would be pressing them to impinge more on savings and get the consumption up. Now, that might not work, but these are the avenues of deliberation that would be logical to come up in such a discussion. And whatever did evolve, some clear evidence that action was being taken in each of these three countries—if it were the three—to reinforce, to show that they are committed to following through behind the initial results of intervention would be necessary, or it would fizzle. And it would have to be coordinated. Now, we haven't had real coordination. I mean, Volcker has been here to testify to that several times, and I hope we are getting to the point where we might even see that.

Senator BRADLEY. Mr. Chairman, could I just ask one more question, or would you rather go on?

The CHAIRMAN. I am not sure anybody else has any more questions, so why don't you go ahead, although we have four more witnesses to go.

Senator **Bradley**. All right. Just one other question. If you look at the trade deficit that we have now, and you look then at the net capital flows, would it be fair to say that given the present mix of policies, foreigners are choosing to buy U.S. Government securities more than they are choosing to buy U.S. goods and that's what this does is simply split? One segment of our economy is better off—those who can sell securities—and the other segment of our economy, that has to sell goods, is a lot worse off, given the present mix?

Mr. **Roosa**. Yes; that is certainly right, and the consequences of it, of course, are that it has led some to think that there is no problem about running a big government deficit because half of it—two-thirds of it really—is now financed from foreign funds.

Senator **Bradley**. But it is not a problem for those who can sell securities?

Mr. **Roosa**. Yes.

Senator **Bradley**. Thank you.

The **Chairman**. Mr. Roosa, thank you very much. Excellent testimony.

Mr. **Roosa**. Thank you, Mr. Chairman.

The **Chairman**. Next, we have a panel of Mr. Gary Hufbauer, senior fellow, Institute for International Economics, and Mr. Scott Pardee, executive vice president, Discount Corp. of New York. Mr. Hufbauer, thank you very much.

STATEMENT OF GARY CLYDE HUFBAUER, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. **Hufbauer**. Thank you, Senator. I will be very brief because you have my statement, because Mr. Roosa covered the key points, and because I have a hoarse throat.

The first point I would like to address is pre-1973 thinking on the relation between floating exchange rates and the balance of trade in goods and services. In the 1960's it was widely believed that a system of floating exchange rates would work to maintain an approximate balance between imports and exports. If, for example, imports of oil suddenly shot up—so the story was told—the exchange rate would decline, exports would then go up, and imports of all other products would decline. In short, the exchange rate would act as a corrective mechanism to restore equilibrium. In this story, short-run capital flows played a passive role, and their purpose was to finance temporary imbalances. Long-run capital flows were thought to be relatively stable. This piece of intellectual history is important because as it turned out, and as testimony earlier this morning has indicated, the floating exchange rate system has not worked as an automatic mechanism to restore balance in goods and services trade. Instead, capital flows, short term, long term, huge, and volatile, have come to dominate the determination of exchange rates and trade flows.

Let me turn to the experience between 1973 and 1984 concerning the relationship between changes in the balance of trade and changes in the real exchange rate. In my statement, I have used a very simple test to indicate whether annual real exchange rate changes were trade driven, as the textbook model of the 1960's predicted, or were capital driven, as recent experience would suggest.

The test is as follows. If the current account position improved between last year and this year, and if the real exchange rate got stronger over the year, I say that was a case where the exchange rate was trade driven. Conversely, if the current account improved but the exchange rate got weaker, I judge the exchange rate to have been capital driven. The improved trade position in the second case may be helping the exchange rate go up, but the net outflow of capital dominates the picture with the result that the exchange has in fact been pushed down.

For the United States, the 12-year record is 3 trade-driven years and 9 capital-driven years. For Germany the record is six and six. For Japan it is 8 trade-driven years and 4 capital-driven years. So, if we take these three economic giants, on balance the textbooks were about half right and they were about half wrong. In particular, the textbook story was quite wrong for the United States, and it was generally right for Japan. In retrospect, most economic events are understandable, and this outcome can be explained by the huge international capital flows and the growing use of the dollar as the world currency.

Finally, I would like to turn to the connection between the Government budget deficits and the current account position. In recent years—say, beginning about 1983—the old textbook story of trade balances and exchange rates has been largely replaced by a new story. In this new story the budget deficit receives special prominence. The story goes somewhat as follows. The rising budget deficit drains the pool of savings, interest rates rise, foreign capital flows in, the exchange rate is bid up, and the balance of trade worsens, both to accommodate foreign capital and to finance the budget deficit. Looking at the record for the last 10 years, the predicted correspondence between changes in the fiscal deficit and changes in the current account occurred in 3 years for the United States, but it did not occur in 7 years. For Germany the record was six and four, Japan four and six.

I conclude from this simple exercise that the budget deficit and the current account deficit are not twins. They may not have the same parents. Probably they are cousins. I think a glance at the sources and use of national savings, which appears in my statement, shows that a larger budget deficit can be offset by many events in the economy, and need not necessarily be offset by a current account deficit. Thank you.

The CHAIRMAN. Mr. Pardee?

[Mr. Hufbauer's prepared statement follows:]

FLOATING EXCHANGE RATES,
TRADE DEFICITS, AND BUDGET DEFICITS

Statement

Gary Clyde Hufbauer
Senior Fellow
Institute for International Economics

My statement is addressed to three questions.

First, how did contemporary observers in the late 1960s and early 1970s expect a system of floating exchange rates to work in terms of the connection between balance of trade changes and exchange rate changes?

Second, what has been the observed relation between balance of trade changes and exchange rate changes since the inauguration of floating exchange rates in March 1973?

Third, how strong is the connection between government budget deficits and balance of trade deficits?

1. Pre-1973 thinking on the relation between floating exchange rates and the balance of trade in goods and services.

In the 1960s, it was widely believed that a system of floating exchange rates would work in the following manner, starting from a position of equal imports and exports of goods and services:

(a) An adverse "shock" (higher income, crop failure, etc.) would cause the country's imports to rise or exports to drop;

(b) The trade deficit would create an excess supply of the national currency in the foreign exchange market;

(c) The exchange value of the national currency would drop; the country's exports would become cheaper to foreigners; and its imports would become more expensive to citizens;

(d) Exports would increase, imports would decrease, and, as a result, balance would be restored in the country's trade in goods and services.

A favorable "shock" would set a reverse chain of events in motion: the exchange value of the national currency would rise and again balance would be restored in goods and services trade.

In this story, short-run capital flows played a passive role. Their purpose was to finance temporary imbalances in the trade account. Long-run capital flows were thought to be reasonably stable. If a country had a net long-run inflow of capital, then it would run a persistent trade deficit to the same extent; if a country had a net long-run outflow of capital, then it would run a persistent trade surplus.

Many illustrations of this view may be culled from the textbooks of the 1960s and early 1970s. Some examples follow.

Walter Krause, International Economics, 1965, p. 91:

> [C]hanges in the rate of exchange serve to equilibrate the supply of and demand for foreign exchange because they entail, in effect, an alteration in the prices of internationally-traded goods and hence lead to modification in the course of trade itself. . . .
>
> The effect upon the United States of an appreciation of the dollar (a depreciation of the pound sterling) is to discourage its exports to, and to encourage its imports from, Great Britain (since dollars come to have increased purchasing power when used to acquire British goods and pounds sterling come to have reduced

purchasing power when used to acquire American goods). Conversely, a depreciation of the dollar (an appreciation of the pound sterling) discourages British sales to the United States and encourages British purchases from the United States. . . .

Peter B. Kenen, International Economics, 1965, p. 58:

If exchange rates were free to fluctuate, an excess demand for foreign currency would cause the dollar to depreciate. It would depress the price of the dollar in terms of foreign currency or, what is the same thing, would raise the dollar price of foreign currency. This change in the exchange rate could, in turn, alter the flow of trade. If the French franc were selling for $0.25 to start, a French car costing 6,000 francs would sell for $1,500. An excess demand for foreign currency that raised the dollar price of the French franc to $0.40 would raise the dollar price of the French car to $2,400. Americans would buy fewer French cars. Similarly, an American machine costing $10,000 would at first sell for 40,000 francs, but only 25,000 francs after the depreciation of the dollar. French industry would buy more American machines. A decrease of US automobile imports, however, will be reflected in the U.S. demand for foreign currency and, therefore, in the supply of dollars on the foreign-exchange market. Likewise, an increase in US machinery exports will be reflected in the French demand for US dollars.

Robert M. Stern, The Balance of Payments: Theory and Economic Policy, 1973, p. 71:

It should be clear from our discussion that under a system of freely fluctuating exchange rates the process of balance-of-payments adjustment works automatically through the changes which occur in imports and exports in response to changes in relative prices associated with exchange-rate variations. Thus, a balance-of-payments deficit or surplus can exist only in an incipient sense in view of the automatic equilibrating forces always at work. These forces are, of course, part and parcel of the competitive market-equilibrium adjustments that will occur in the respective countries in accordance with our assumptions. We know from the theory of comparative advantage that under competitive conditions free international trade will result in an optimal allocation of resources for the world as a whole. A system of freely fluctuating exchange rates is to be looked upon, therefore, as the monetary counterpart of a system of free international trade. The essence of the argument in support of freely fluctuating exchange rates is to be understood accordingly in terms of optimal resource allocation. As will become clear shortly, our criterion of optimality is to be interpreted with respect to the present-day system of the adjustable peg in which government intervention often results in the misallocation of resources.

Charles P. Kindleberger, International Economics, Fifth edition, 1973, p. 381 (describing the Laursen-Metzler model of flexible exchange rates):

> Let us set the stage by noting the balance of-payments behavior of the economy. When changes in the demand for exports or supply of imports occur, the economy adjusts to them readily and smoothly by means of changes in the exchange rate and costless and speedy reallocations of domestic resources. If, for example, the demand for exports falls off, the exchange rate will depreciate to the point where newly induced exports, or reduced imports, automatically offset the original change. If the demand for exports increases, exchange appreciation leads to displacement of incremental exports, or the stimulation of incremental imports, to match the initial change. The balance of payments is always in balance. The amount of spending on domestic resources is constant, as a first approximation, because the change in foreign spending on exports is matched either by other changes in spending on exports, as a result of depreciation, or by other changes in spending on the domestic output of import substitutes, as imports change. If exports fall, for example, and imports fall to match, the decline in foreign spending for exports is counterbalanced by an increase in domestic spending on import substitutes. This calls for a smooth and frictionless transfer of domestic resources from the export sector to the import-competing sector.

Qualifications to the basic story can be found, especially in advanced expositions of the floating exchange rate system. But vintage 1960/1970 university students and government policy makers can be forgiven if they came away thinking that floating exchange rates would, over a short period of time, ensure approximate balance in a nation's trade in goods and services (making due allowance for "stable" long-term capital flows). This piece of intellectual history is important because, as it turned out, the floating exchange rate system has not worked as an automatic mechanism to restore balance in goods and services trade. Instead, huge and volatile capital flows--both short-term and long-term--have come to dominate the determination of exchange rates and the balance of trade in goods and services.

2. Experience between 1973 and 1984 concerning the relationship between changes in the balance of trade and changes in the real exchange rate.

Table 1 summarizes the record for the three economic giants, the United States, Germany and Japan, over the period 1973 to 1984. The table gives the annual current account position (i.e., the balance on trade in goods and services), expressed as a percentage of Gross Domestic Product (GDP). The table also gives the change in the real exchange rate from one year to the next. Real exchange rates are defined to reflect each country's geographic composition of trade and changes in its wholesale prices and unit labor costs. The underlying estimates of real exchange rates were calculated by my colleague, John Williamson.[1]

I have used a simple test to indicate whether annual real exchange rate changes were "trade driven" (T)--as the textbook model of the 1960s predicted--or "capital driven" (C)--as more recent experience might suggest.[2] The labels "T" and "C" could also be thought of as "Truth" or "Consequences".

If the current account position has improved between last year and this year, and if the real exchange rate has gotten stronger over the year, I judge the exchange rate to be "trade driven". Just as textbooks predicted, a stronger balance of trade in goods and services has led to a higher real exchange rate.[3] Likewise, if the current account has worsened and the exchange rate is weaker, I judge the exchange rate to be "trade driven." Over time, "trade driven" exchange rates should work to correct departures from equilibrium in the trade account.

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[1] John Williamson, The Exchange Rate System, Institute for International Economics, Washington, September 1983.

[2] The use of real exchange rates in this test, rather than nominal exchange rates, takes into account inflation rate differentials between countries. Differencies in inflation rates would be expected to alter nominal exchange rates over a period of time, quite apart from the impact of changes in the current account.

If the current account has improved but the exchange rate has gotten weaker, I judge the exchange rate to be "capital driven." The improved trade position may be helping the exchange rate, but the net outflow of capital dominates the picture, with the result that the exchange rate has been pushed down. Likewise, if the current account position has worsened but the exchange rate has gotten stronger, I judge the exchange rate to be "capital driven." This is the story of the United States since 1981: a weak balance of trade and a strong dollar. As that experience indicates, "capital driven" exchange rates need not work to correct departures from equilibrium in the trade account; in fact, they can work in just the opposite direction.

An examination of Table 1 shows that, overall, "T's" are less numerous that "C's". For the United States, the 12 year record is only 3 "T's" and 9 "C's". For Germany, the record is 6 "T's" and 6 "C's". For Japan, the record is 8 "T's" and 4

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[3] In fact, forces other than the stronger balance of trade may have pushed the exchange rate up, but I give the benefit of the doubt to the textbook story.

"C's". All told, Table 1 has 17 "T's" and 19 "C's".

On balance, the textbooks of the 1960s were about half-right. That means they were half-wrong. In particular, the textbook story was badly off the mark for the United States, but it was generally right for Japan.[4]

This outcome is not surprising in view of the explosive growth of international capital flows and the growing use of the dollar as a world currency. In 1974, some 0.2 million currency futures contracts traded on the International Monetary Market. In 1983, the volume reached 11.9 million contracts. Meanwhile, Central Banks continue to hold some 70 percent of their foreign exchange reserves in dollars, and a very large proportion of foreign debt and third country trade is denominated in dollars.

Is there any reason to worry if exchange rates are "capital-driven" rather than "trade-driven"? To a foreign exchange trader or a Wall Street banker, it probably makes very little difference. So long as transactions are brisk and he guesses right on tomorrow's exchange rates, the world is fine.

To a farmer selling soybeans in Europe, or a steel producer competing with plate and sheet from Korea, the picture looks rather different. He cares a great deal about the level of exchange rates. When the U.S. dollar is 35 percent overvalued, as it was in the first quarter of 1985, he knows the meaning of pain.

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[4] According to an analysis by William R. Cline, the textbook story worked better before 1981 than after. See William R. Cline, "Global Consequences of U.S. External and Internal Disequilibria," Stanford University, Conference on United States-Mexico Trade and Financial Interdependence, September 15-17, 1983.

Incidentally, the magnitude of yen appreciation over the past four years has been far smaller than the textbook story would suggest. The extent of yen appreciation has come no where near correcting Japan's current account surplus.

3. The connection between government budget deficits and the current account position.

The old textbook story of trade balances and exchange rates has almost been replaced by a new story. In the new story, the budget deficit receives special prominence. Often associated with the name of Martin Feldstein, the new story has been told countless times by editorial writers, foreign statesmen, and TV commentators. Briefly, the story runs as follows:

(a) A rising government budget deficit drains the national pool of savings;

(b) Interest rates rise;

(c) Foreign capital flows in, attracted by high interest rates;

(d) The exchange rate is bid up and the balance of trade in goods and services worsens, both to accommodate the inflow of foreign capital and, indirectly, to finance the budget deficit.

According to this story, the government budget deficit and the current account deficit are fraternal twins. What does the experience of the last decade say?

Table 2 records the government fiscal deficit (federal and subfederal) as a percent of GNP for the United States, Germany, and Japan. It also records the current account position as a percent of GDP.[5] According to the fraternal twin story, an increase in the fiscal deficit should be matched by a decrease in the current account position. Table 2 shows the "supposed" change in the current account position that would result if the fraternal twin thesis held up. Table 2 also shows the "actual" change in the current account position.

Economics is not an exact science, and I do not apply an exacting test to the fraternal twin thesis. If the "supposed" change in the current account exhibits the same sign as the "actual" change, a "T" is recorded in Table 2. Otherwise an "F" is shown.

For the United States, the predicted correspondence occurred in 3 of the past 10 years--in other words, 3 "T's" and 7 "F's". For Germany, the record was 6 "T's" and 4 "F's". For Japan, 4 "T's" and 6 "F's.

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5. Gross national product (GNP) and gross domestic product (GDP) are virtually the same for large countries such as the United States, Germany, and Japan.

The budget deficit and the current account deficit are certainly not twins. They may not even have the same parents. Perhaps they are cousins.

A glance at the sources and uses of national savings--shown in Table 3 for the United States for 1984--suggests that a larger budget deficit could be offset by various changes other than an increase in foreign capital inflows. There is no logical reason why a change in the budget deficit should be precisely offset by a change in the current account deficit.

Clearly there is a twin relationship between the total sources and the total uses of savings. Apart from any statistical discrepancy, the two must be equal. But because the totals are twins does not mean that any particular components are twins.

A larger government deficit could push up interest rates and drive down gross private domestic investment. Or it could stimulate economic activity, boost prices, and raise gross business savings. Other scenarios could be told.

There are many good reasons to reduce the federal budget deficit. It is certainly possible--I would say likely in present circumstances--that a reduction in the budget deficit would help bring down the trade deficit, mainly through its impact on the exchange value of the dollar. But history gives no guarantee that a reduction in the budget deficit will be matched by a reduction in the current account deficit. Conversely, it is certainly possible that the current account deficit can be sharply reduced even without a significant cut in the budget deficit.

4. Conclusions

Contrary to the teachings of the 1960s and 1970s, "shocks" in the balance of trade are not reliably followed by self-correcting changes in the exchange rate. Contrary to the teachings of the 1980s, government budget deficits do not necessarily find a mirror reflection in the balance of trade. In both these stories, the exchange rate was regarded as a passive mechanism, waiting to transmit forces originating elsewhere in the economy. In my view, the stories have gone wrong because, as often as not, the exchange rate leads a life of its own, driven by "animal spirits" that inhabit the world of financial speculation. I conclude that, if the U.S. Congress is concerned about the balance of trade in goods and services, it should persuade the Secretary of the Treasury to take a decidedly more sympathetic attitude towards managing the exchange rate. Some wars are too important to be left to the generals, and some prices are too important to be left to the market. The exchange rate is one of those prices.

In testimony delivered before this Committee on June 28, 1984, I outlined three "unorthodox" solutions for the U.S. trade deficit.[6] Those solutions involve deliberate changes in the exchange rate, or other changes in relative prices, that would promote U.S. exports and retard U.S. imports. That testimony bears rereading, but I will not bore you by repeating its message at length.

Briefly:

1. My preferred short term solution involves coordinated exchange rate intervention by the Central Banks. The objective of intervention would be to rocket the mark and the yen, and to correct the dollar by about 35 percent. Over a period of years, this correction would improve the U.S. trade position by about $110 billion--about $3.2 billion for every 1 percent correction in the trade-weighted value of the dollar.[7] A correction of some 35 percent could simultaneously increase U.S. gross business savings by $100 billion annually, thereby providing domestically much of the savings that now come from abroad.[8]

2. The United States and other GATT countries should allow adjustment at the border for direct taxes. Permission for adjustment should, however, be given to countries only after they have experienced both significant overvaluation of their

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6. Gary Clyde Hufbauer, "The U.S. Trade Deficit: Three Unorthodox Solutions," Statement before the Subcommittee on Trade, Senate Committee on Finance, June 28, 1984.

7. This estimate is extrapolated from Stephen Marris' forthcoming study on Deficits and the Dollar, Institute for International Economics, Washington.

8. This estimate assumes that the traded goods sector of the U.S. economy amounts to about $1,000 billion; that a 35 percent exchange rate correction would increase prices for this sector by 10 percent; and that, in the short run, higher prices would be translated into larger gross business savings.

currencies and large current account deficits. With an average border tax adjustment of about 5 percent that was not matched by our trading partners, the United States might improve its current account position by about $16 billion annually.

3. Surplus countries, such as Japan, should unilaterally liberalize their government and non-government barriers to trade. According to my very rough guesstimates, if Japan totally liberalized, Japan's increase in imports from the United States would be about $10 billion, and Japan's increase in imports from all countries would be about $17.5 billion. These amounts would help reduce the projected 1985 Japanese current account surplus of $37 billion.[9]

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[9] The reduction in the current account surplus might be somewhat less than the increase in imports, because higher imports might depress the yen, thereby stimulating Japanese exports.

Table 1. Current account position as percentage of GDP and real exchange rate change in percent for the United States, Germany and Japan.

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
United States													
Current account	-0.5	0.5	0.3	1.2	0.3	-0.7	-0.7	-0.1	0.2	0.1	-0.3	-1.0	-2.8
Real exchange rate change		-8.9	-2.0	-3.0	3.4	-1.9	-7.0	-0.1	1.3	14.3	10.6	3.1	7.2
Trade driven (T) or capital driven (C)		C	T	C	C	T	C	C	T	C	C	C	C
Germany													
Current account	0.4	1.3	2.7	1.0	0.9	0.8	1.4	-0.8	-1.8	-0.8	0.6	0.7	1.0
Real exchange rate change		9.6	0.6	-5.3	0.1	3.2	2.6	1.7	-3.2	-9.6	1.3	-0.5	-4.0
Trade driven (T) or capital driven (C)		T	T	T	C	C	T	C	T	C	T	C	C
Japan													
Current account	2.3	0.0	-1.0	-0.1	0.7	1.6	1.7	-0.9	-1.1	0.5	0.7	1.8	2.8
Real exchange rate change		8.9	3.3	-8.0	1.2	5.0	12.5	-12.8	-7.5	7.8	-9.0	7.7	2.1
Trade driven (T) or capital driven (C)		C	C	C	T	T	T	T	T	T	C	T	T

Notes:

"Current account" is the balance on trade in goods and services, expressed as a percentage of GDP. A current account deficit is shown by a minus sign.

"Real exchange rate change" is the percentage change in the real effective exchange rate (REER). The REER takes into account changes in wholesale prices, unit labor costs, and the geographic distribution of trade. See Williamson, op. cit. The real exchange rate change is judged to be "trade driven" if it agrees in sign with the change from the prior year to the current year in the current account position. It is judged to be "capital driven" if it does not agree in sign with the change in the current account position.

Sources:

John Williamson, The Exchange Rate System, Institute for International Economics, Washington, September 1983, Appendix Table A1. Also updated figures from the author.

OECD, Economic Outlook 36, December 1984, Table R5, p.170.

Bank of America, International Economic Newsletter, April 1985.

Table 2. Correspondence of government fiscal deficits as percentage of GNP and current account positions as percentage of GDP for the United States, Germany, and Japan.

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
United States											
Fiscal deficit	0.3	4.2	2.1	0.9	-0.2	-0.6	1.2	0.9	3.8	3.9	3.1
Current account	0.3	1.2	0.3	-0.7	-0.7	-0.1	0.2	0.1	-0.3	-1.0	-2.8
Change in current account:											
Supposed		-3.9	+2.1	+1.2	+1.1	+0.4	-1.8	+0.3	-2.9	-0.1	+0.8
Actual		+0.9	-0.8	-1.0	0.0	+0.6	+0.3	-0.1	-0.4	-0.7	-1.8
Same signs (T) or different signs (F)		F	F	F	F	T	F	F	T	T	F
Germany											
Fiscal deficit	1.3	5.7	3.4	2.4	2.5	2.7	3.1	3.8	3.5	2.7	1.4
Current account	2.7	1.0	0.9	0.8	1.4	-0.8	-1.8	-0.8	0.6	0.7	1.0
Change in current account:											
Supposed		-4.4	+2.3	+1.0	-0.1	-0.2	-0.4	-0.7	+0.3	+0.8	+1.3
Actual		-1.7	-0.1	-0.1	+0.6	-2.2	-1.0	+1.0	+1.4	+0.1	+0.3
Same signs (T) or different signs (F)		T	F	F	F	T	T	F	T	T	T
Japan											
Fiscal deficit	-0.4	2.7	3.7	3.8	5.5	4.8	4.5	4.0	3.4	3.1	2.3
Current account	-1.0	-0.1	0.7	1.6	1.7	-0.9	-1.1	0.5	0.7	1.8	2.8
Change in current account:											
Supposed		-3.1	-1.0	-0.1	-1.7	+0.7	+0.3	+0.5	+0.6	+0.3	+0.8
Actual		+0.9	+0.8	+1.9	+0.1	-2.6	-0.2	+1.6	+0.2	+1.1	+1.0
Same signs (T) or different signs (F)		F	F	F	F	F	F	T	T	T	T

Notes:

"Fiscal deficit" is the conventionally defined general government deficit (federal and subfederal together), expressed as a percentage of GNP. A fiscal surplus is shown by a minus sign.

"Current account" is the balance on trade in goods and services, expressed as a percentage of GDP. A current account deficit is shown by a minus sign.

The "supposed" change in the current account is the presumed change in the fiscal deficit from the prior year to the current year, expressed as a percentage of GDP, on the "fraternal twin" assumption that a 1.0 percentage point *increase* in the fiscal deficit results in a 1.0 percentage point *decrease* in the current account surplus.

The "actual" change in the current account is simply the measured change from the prior year to the current year, expressed as a percentage of GDP.

If the "supposed" and "actual" changes exhibit the same sign, a T is shown; if they exhibit different signs, an F is shown.

Sources: Vito Tanzi, "The Deficit Experience in Industrial Countries," in Phillip Cagan, editor, *Essays in Contemporary Economic Problems, 1985: The Economy in Deficit*, American Enterprise Institute, Washington, 1985.

OECD, *Economic Outlook 36*, December 1984, Table R5. p.170.

Table 3: United States sources and uses of savings, 1984.

	Billion dollars
Sources of savings	
Personal savings	157
Gross business savings	520
Foreign savings (equals current account deficit, with minor adjustments)	95
State and local surplus	50
Total sources	822
Uses of savings	
Federal deficit	175
Gross private domestic investment	637
Total uses	812
Statistical discrepancy	10

Source: Estimated from data given in Council of Economic Advisers, Economic Report of the President, Washington, 1985.

STATEMENT OF SCOTT E. PARDEE, EXECUTIVE VICE PRESIDENT, DISCOUNT CORP. OF NEW YORK, NY; FORMER SENIOR VICE PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK AND MANAGER FOR FOREIGN EXCHANGE OPERATIONS, FEDERAL RESERVE SYSTEM

Mr. PARDEE. Thank you very much. The dollar's strength over recent years has benefited many Americans but has hurt others to the extent that corrective action may be necessary.

In the 1970's, the reverse was true. Some exchange rates are clearly wrong in a policy sense. Market dynamics play a major role in the emergence of wrong exchange rates. Exchange rates can move 1 or 2 percent in a matter of minutes, 5 percent or so in a matter of days, 10 percent or so in a matter of weeks, and 50 percent or so in a matter of a year. Exchange rates do not rise or fall in a vacuum. A rate which is driven to extreme levels merely by market forces will very soon begin to affect the rest of the economy. Instead of having an exchange rate adjust to underlying economic conditions, there is the risk to the economy that domestic prices and jobs will adjust to exchange rates which have been pushed to exaggerated levels. At times a stampede psychology takes hold and there is a full-scale run on the currency, just as there is a run on a bank. Such are extreme examples of the kind of disorderly conditions which are used as a rationale for direct intervention by the authorities in the exchange market.

Unfortunately, central bank intervention has become a value-laden term for people of various economic persuasions in this country. I have conducted intervention operations for the Federal Reserve and the U.S. Treasury from the years 1975 to 1981. Intervention is not a panacea. Not to intervene, however, leaves our Nation's currency at the mercy of market forces. It also leaves active intervention policy totally in the hands of foreign authorities. Central bank cooperation is strictly in the U.S. self-interest. Through our willingness to intervene we can get the authorities of other countries to cooperate with us. By leaving the field of action completely to them, the United States loses a good deal of influence on the foreign exchange operations of foreign governments.

For the first time since the war, the United States now faces effectively a common dollar policy among the major European countries. They act in concert in intervention in the currency markets for the dollar whether the United States is willing to join or not. What to do? I cannot overemphasize the damage that the United States fiscal deficit is doing to us. Much of that has been reviewed here already. I also think that too much is being asked of the Federal Reserve to conduct a variety of policies in view of the many objectives that it has. The Federal Reserve needs additional policy tools to deal with these problems, each in its own way.

Specifically, I feel that the Fed should have a greater freedom to intervene in the exchange market than has been allowed by the U.S. Treasury in recent years. Otherwise, we risk dilemma situations where the Federal Reserve might be forced to ease monetary policy because the dollar is strong or to tighten monetary policy because the dollar is weak and when such actions are not justified for domestic reasons. My suggestion at this point is one that befits the strategic importance of the dollar in the United States and to the free world. A further sharp rise in dollar exchange rates is not in our interest at this time. At the same time, a sharp reversal of the dollar which could cumulate just as easily as has the rise is not in our interest either.

I believe, therefore, that this is the time to begin building a strategic currency reserve in German marks, Japanese yen, Swiss francs, and other major currencies. The purchases would be on a day-to-day basis, market conditions permitting. The effect, of course, would be to lean against the wind to moderate the rise of the dollar. On days when the dollar might be easing or flat, then the program could be suspended. Then when the dollar declines, which sooner or later it will, the United States authorities will have some reserves to feed back into the market to lean against the wind and avoid an inflationary overshooting in the opposite direction. Second, I believe that the Federal Reserve should be allowed to become a regular modest participant in the market. The operation of accumulating a currency reserve would help. It has no assurance of continuity. One means of participating might be for the Federal Reserve to conduct open market operations through both the domestic open market desk and the foreign desk. Foreign central banks frequently use exchange market operations—swaps and the like—to add or drain liquidity. Another technique would be for the foreign desk to make markets to interbank dealers when trading becomes especially ragged, that is, to be prepared to buy and sell currency when market makers aren't sure of their footing. We conducted such operations successfully a number times in the late 1970's and early 1980's. These and other kinds of operations I could suggest are highly technical, but they would work toward restoring the breadth, depth, and liquidity of the exchange market. That is my statement, Mr. Chairman.

[Mr. Pardee's prepared statement follows:]

THE RIGHT APPROACH TO WRONG INTEREST RATES

SCOTT E. PARDEE

EXECUTIVE VICE PRESIDENT

DISCOUNT CORPORATION OF NEW YORK

No exchange rate for the dollar is the right rate for everyone. A strong dollar benefits the American consumer by keeping inflation down at home and enhancing our purchasing power abroad. For the same reason it benefits U.S. industries which depend heavily on foreign suppliers of raw materials or components. And it encourages foreign investment in U.S. equities, bonds, real estate, and many other assets. For the Administration, the strong dollar has been considered a badge of success in other areas---a sound economy, low inflation, political stability---which enhances America's prestige and bargaining power in world affairs. For the U.S. Treasury, the strong dollar has facilitated the marketing of U.S. government securities to foreign investors at a time when the huge fiscal deficits are absorbing the lion's share of domestic savings. For the Federal Reserve, the strong dollar has kept a check rein on inflation.

But the dollar's strength has also created many serious problems. It has hurt many U.S. industries competing with foreign producers and has led to a severe loss of jobs in some of those industries. It has clearly dampened the growth of GNP over recent quarters and could conceivably lead to negative growth in the quarters ahead. For the Administration, the strong dollar has generated increased pressure for protection by those domestic industries which have been hurt, and by those Americans whose jobs have been lost or threatened, in direct challenge to the nation's commitment to free markets and liberal trading practices. Protectionist action here would surely invite retaliation abroad, with little net gain for either U.S. or our trading partners---and perhaps even a net loss to all. As it is, the strong dollar has complicated the Administration's direct relations with foreign leaders who are unwilling to accept that the weakness of their currencies against the dollar should be considered a badge of failure for them and their policies. This is why foreign exchange matters are so hotly debated at Economic Summits these days. Nor is the strong dollar an unmitigated blessing for the Treasury. Slower growth at home means lower tax revenues than otherwise, swelling the fiscal deficit which must be financed. And for the Federal Reserve, slow growth complicates monetary policy, forcing the Fed to maintain an easier policy than it might otherwise want in its efforts to wring inflation out of the economy.

There is thus a case to be made for doing something to keep the dollar from becoming in some sense too strong---such that the damage outweighs the immediate benefits. This would mean taking action to keep the dollar from rising sharply again in the exchange markets and perhaps even to push it down from current levels.

I would like to stress that in the 1970's we had the opposite problem. The weak dollar helped some Americans and hurt others. Ultimately the damage became so great, in terms of increasing inflation here and the loss of confidence in the U.S. abroad, that the U.S. authorities took action to halt the dollar's slide and even to turn it around.

With so many conflicting interests in the market, it is impossible to say what should be the right exchange rates for the dollar, but there are levels which are clearly wrong in a policy sense. I will not try to define "wrong rate" specifically for the same reason the drafters of the Articles of Agreement of the International Monetary Fund decided not to define "fundamental disequilibrium" as the rationale for adjusting an exchange rate parity under the Bretton Woods fixed rate system. It is a matter of judgment for the authorities in power at the time. On those occasions, action should be taken to avoid an even further adverse swing in rates or even to correct the excessive swing which has already occurred. Ideally, the authorities should take action to avoid the conditions from which wrong rates emerge in the first place.

The emergence of wrong rates frequently has less to do with economic fundamentals and economic policy than with market dynamics. For any exchange market participant, trading currencies is a very hazardous business. Markets are effectively open around the clock. Events in any part of the world can spark a surge of buying or selling of dollars. Daily turnover these days averages some $200 billion. Nevertheless, some players deal in large amounts and can influence rates by the trades they do or by the very rumor that they are buying or selling---the Foreign Trade Bank of the Soviet Union is perhaps the most discussed swinger in the interbank market right now, and there are others. In markets other than foreign exchange, there is a certain virtue in being a contrarian. In foreign exchange markets today it is suicidal. The best strategy is to find the trend and then ride it---or as they say in the currency pits in Chicago, the trend is your friend. Exchange rates can move 1 or 2% or so in a matter of minutes, 5% or so in a matter of days, 10% or so in a matter of weeks, and 50% or so in a year. Generating a trend or catching one right is exceedingly difficult. Sudden shifts in market psychology can lead to sharp swings in rates and to punishing losses to those who are caught in the wrong position. Volatility forces market makers to step back, widen their bid-asked spreads, and to cover long or short positions quickly. In this environment, the market loses depth, breadth and resiliency, and exchange rates can rise or fall cumulatively, driven by the dynamics of market forces.

Exchange rates do not rise and fall in a vacuum. A rate which is driven to extreme levels merely by market forces will very soon begin to affect the rest of the economy. Instead of having the exchange rate adjust to underlying economic conditions, as the textbooks suggest, there is the risk that the economy---that is domestic prices and jobs--- will adjust to exchange rates which have been pushed to exaggerated levels.

The textbooks suggest that counterbalancing forces will quickly emerge within the exchange market, and normally this happens. At times, however, a stampede psychology takes hold and there is a full-scale run on a currency, just as there is a run on a bank. Everyone wants out at the same time---all sellers and no buyers.

I have seen several such runs in my own experience, on the dollar and on other currencies, and they are frightening in themselves. They are extreme examples of the kind of "disorderly market conditions" which are used as the rationale for direct intervention by the authorities in the exchange market. This intervention is done by the central bank buying or selling currencies in the market, operating with balances at hand or from credit lines.

Unfortunately, central bank intervention has become a value-laden term for people of various economic persuasions in this country, something to be for or against in an ideological sense. It is also a controversial concept in the market, where the decision to intervene pits the central bank against the very market participants who are profiting from the trend the central bank is trying to stop. Is intervention necessary? Does it work? Is it profitable? Some people say yes to all these questions, some say no. I am a pragmatist. Sometimes intervention has been necessary, sometimes it works, and sometimes it is profitable. At other times it can be disastrous.

Intervention is not a panacea. If fiscal policy is too expansive, if monetary policy is too expansive, if an Administration loses the confidence of traders in the markets, then intervention can be counterproductive except as a means of buying time---a holding action--or as a means of damage control---a rear guard action. For all the talk about the strong dollar, right now I believe that the next big move for the dollar will be lower. The fiscal deficit and the trade deficits are just too large, and foreign investors are becoming increasingly chary of placing new funds here.

Not to intervene however, leaves our nation's currency at the mercy of market forces. It also leaves active intervention policy totally in the hands of foreign authorities. Since the early 1960's, I and others in the international financial community have extolled the virtues of central bank cooperation. This is strictly in the U.S. self-interest. Through our willingness to intervene we can get the authorities of other countries to cooperate with us. By leaving the field of action completely to them in the last four years, the U.S. has lost a good deal of our influence on the foreign exchange operations of foreign governments. For the first time since the war, the U.S. now faces effectively a common dollar policy among the major European countries. They act in concert in intervention in the currency markets for the dollar whether or not the U.S. is willing to join.

By not intervening, the U.S. authorities lose touch with the market. A central bank that is not a regular participant in the market is not going to get complete and accurate information on what is happening. Foreign exchange traders are after all businessmen and women, and many of them are unwilling even to answer the phone unless they believe the call could result in a trade.

What to do? I cannot overemphasize the damage that the huge fiscal deficit is doing to us. To the extent that the deficit has raised interest rates here, it has contributed to the strong dollar that has hurt so many sectors of the U.S. economy. Until now, foreign investors have remained confident in the outlook for the U.S. However, no nation in history has run a large deficit for very long without ultimately undermining the value of its own currency. Unless the fiscal deficit is curbed, it is just a matter of time before the confidence ebbs and the dollar falls.

I also think too much is being asked of the Federal Reserve right now---to keep the economy going, contain inflation, keep the financial system sound in the face of widespread credit problems at home and abroad, adjust to a world which is increasingly deregulated, and, if necessary, to counter disorderly conditions in the exchange market. The Federal Reserve needs additional policy tools to deal with these problems, each in its own way.

Specifically, I believe the Fed should have greater freedom to intervene in the exchange market than has been allowed by the Treasury in recent years. Otherwise we risk the dilemma of having the Federal Reserve forced to ease monetary policy because the dollar is strong or tighten monetary policy because the dollar is weak when such actions are not justified for domestic reasons.

This dilemma is real. In recent months the U.K. authorities chose to deal with an excessive decline of the pound sterling by intervening only modestly while tightening monetary policy drastically, jacking up interest rates to astronomical levels--a risky approach in view of the high unemployment level in that country. By contrast, the West German authorities responded to a weakening of the mark against the dollar by intervening forcefully, in coordination with other central banks while tightening monetary policy only modestly--seeking to avoid aggravating domestic unemployment. Right now, both strategies seem to have worked, but the one based on forceful intervention was less risky as far as domestic jobs were concerned. The interventions ---which totaled more than $10 billion---were also highly profitable, by more than $1 billion in view of the dollar's subsequent 10% decline. That's good trading by any measure.

My suggestion at this point is one which befits the strategic importance of the dollar to the U.S. and to the Free World. A further sharp rise in dollar exchange rates is not in our interest at this time. At the same time, a sharp reversal of the dollar, which could cumulate just as easily as has the rise, is not in our interest either. The United States government has over the years stockpiled strategic materials, against dire but unforeseen contingencies. The U.S., unlike other countries, has never amassed a foreign currency reserve, depending on our gold stock during the Bretton Woods days, and on the Federal Reserve swap network and other credit facilities when we needed currencies during the 1960's and 1970's. The credit facilities are still on the books but the spirit of cooperation which made them work is gone. The next time around, the defense of the dollar will have to be conducted largely by the U.S. before other countries could be persuaded to join in on any form of cooperative venture.

I believe, therefore, that this is the time to begin building just such a strategic currency reserve, in German Marks, Japanese Yen, Swiss Francs and other major currencies. The purchases would be on a day-to-day basis, market conditions permitting. The effect, of course, would be to lean against the wind, to moderate the rise of the dollar. On days when the dollar might be easing, or flat, the program would be suspended. Then when the dollar declines--which sooner or later it will--the U.S. authorities will have some reserves to feed back into the market, to lean against the wind and avoid an inflationary overshooting in the opposite direction. If the fiscal deficit is not curbed, if the Federal Reserve is forced to monetize it, if inflation revives in the U.S. for whatever reason, the dollar could again become the whipping boy of the exchanges, with profound implications for trade and financial markets, not to speak of our prestige.

Second, the Federal Reserve should be allowed to become a regular modest participant in the market. The operation in accumulating a currency reserve would help but has no assurance of continuity. One means of participating might be for the Federal Reserve to conduct open market operations through both the domestic open market desk and the foreign desk. Foreign central banks frequently use exchange market operations, swaps and the like, to add or drain liquidity. The Federal Reserve might consider similar operations. Another technique would be for the foreign desk to make markets to interbank dealers when trading becomes especially ragged, that is, be prepared to buy or sell currencies when market makers are unsure of their footing. Transactions would be reversed as soon as trading conditions are restored. We conducted such operations on several occasions in the late 70's and early 80's. They generally had the effect of calming the market and helped gain the respect of the dealer community. We also made money at it. By this means we improved our information flow and could be much more effective when conducting larger scale interventions. These and other kinds of operations I could suggest are highly technical, but they would work toward restoring the breadth, depth, and resiliency of the exchange market. I have no plan for reforming the international monetary system. I just think we should try to make the system we have work better.

The **Chairman**. Senator Moynihan?

Senator **Moynihan**. Mr. Pardee, could we ask you about something that has been, I think, the continuing theme of our inquiries today? How do we get from where we are to where you would like us to be? Is this something that, basically, Treasury has to decide and to which the President must agree, or is this something Congress can give direction to? It is very hard for an amorphous group such as ours to make as precise a kind of decision that you are talking about. You have had experience in this, and we do follow leadership. In the absence of leadership, we are trying to formulate some route of our own, but it is going to be incoherent at best. How would you like to see this? Where is the locus of initiative in this ring?

Mr. **Pardee**. With foreign exchange policy, the ultimate decisions rest with the President of the United States, conducted through the U.S. Treasury—that is the first priority here. These matters have been discussed at economic summits. It would be up to the President to step back from his earlier statements and accept more intervention than before. It can be done in the context of language that has already been used. As a rationale for intervention, countering disorderly conditions covers a very wide spectrum. It is up to the Secretary of the Treasury as well. However, I am pleased that this meeting is being held. There has been no national debate on the issue of intervention for many years. A sense of Congress—a sense that this is something that has to be done—could sway the balance of the debate within the administration.

Senator **Moynihan**. So, you think that if the Finance Committee reached some reasonably coherent judgment, just our saying so would have some effect? You are saying that these hearings are a beginning.

Mr. **Pardee**. It is more than we have right now. There are a few lonely people who are suggesting that something should be done and to bring it together in this forum would be very helpful.

Senator **Moynihan**. All right. Thank you very much.

The **Chairman**. Senator Baucus?

Senator **Baucus**. Thank you, Mr. Chairman. I think all of us in this room think that something should be done. Senator Long stated the problem very well when he said he doesn't know how much longer we can go on, but he doesn't want to find out. The question I have is somewhat along the line of other questions. How do we get people's attention in this country, in the administration, or in other countries? There is a lot of talk and a lot of theory here. It is a somewhat abstract problem. People don't really feel that directly. They know that they are losing jobs, but they don't know quite why they are losing jobs. The link is a little bit indirect. Do we need something like an import surcharge to get people's attention?

Mr. **Pardee**. It is difficult in this environment. A strong currency benefits many people in the United States, just as it hurts in many others. It is more a question of mobilizing the people who feel that there is something very wrong. I think slapping on other measures won't necessarily solve the problem.

Senator **Baucus**. I'm not asking about a solution but about how we get their attention.

Mr. **Pardee**. The only way—I was in the Federal Reserve for many years and have been in markets for many years. I would agree with Senator Long—experience shows we need to have a major crisis and get everybody upset. I would like to avoid a crisis by any means, and this is one way.

Senator **Baucus**. If there is to be some kind of market intervention, I would assume that this country—the Federal Reserve and Treasury—has to prepare to go all the way. That is, we can't say there is going to be intervention and then just pay lip service to it.

Mr. **Pardee**. Yes.

Senator **Baucus**. Are we prepared to do that, do you think?

Mr. **Pardee**. I don't think under the current philosophy of the administration——

Senator **Baucus**. What if the philosophy were different? Do we have the ability to buy enough Japanese yen or Deutschmarks to do all this?

Mr. **Pardee**. Yes, we do.

Senator **Baucus**. Can we go far enough to back it up?

Mr. **Pardee**. Yes, we can, as long as we have the political will to do it.

Senator **Baucus**. So, it is really a question of will and philosophy more than it is a question of ability?

Mr. **Pardee**. Right.

Senator **Baucus**. Mr. Hufbauer, I was curious about your recommendation, that we have a border tax adjustment. Why do you recommend that?

Mr. **Hufbauer**. Let me preface my answer, Senator Baucus, by saying I fully subscribe to what has been said about exchange rates. The first and foremost thing that needs to be done is to have a managed policy of exchange rate intervention. When it comes to border tax adjustments and other measures, the numbers indicate that their effects are very much smaller than anything that can be done by the exchange rate.

The **Chairman**. Could you repeat that?

Mr. **Hufbauer**. Yes. The exchange rate is the decisive part of this story. I think other things can be done, and I mentioned two of them, recalling some testimony I gave before the Senate Finance Trade Subcommittee a year ago. But anything else after the exchange rate is going to fall in the small numbers realm.

Put in that context, my reason for advocating a system of border tax adjustments is that present GATT system does not correctly treat direct taxes—especially Social Security taxes and corporate income taxes. As you know, Senator, indirect taxes can be adjusted at the border, but direct taxes cannot. I believe that the GATT system ought to be amended to allow adjustment at the border for direct taxes.

Senator **Baucus**. I appreciate that. What do you think of Mr. Pardee's suggestion of a strategic reserve? It has a lot of appeal for me. Maybe it is a way for the administration to get off of its ideological——

Mr. **Hufbauer**. Oh, that is an absolutely great idea. I have propounded that same idea. I didn't give it the name Strategic Reserve, but that is a great title because it recalls our response to the oil crisis. We should proceed to acquire this $50 billion or $70 billion of foreign exchange. Indeed, to not build a Strategic Reserve is imprudent policy.

If I could just take 20 more seconds, the first step is to change people's minds. When we talk about the exchange market, we are really only talking about a handful of people whose minds need to be changed. There is the Chairman of the Federal Reserve, and his views may not need to be changed. There is the new Secretary of the Treasury, and he has been ambiguous. And then there is Mr. Sprinkle, and we know his views—he is dead set against any management of exchange rates. And then, of course, all important, there is the President.

Senator BAUCUS. He is pretty important.

Mr. HUFBAUER. He is very important. But I think a change of mind on exchange rate policy is nowhere near as difficult as a change of mind on budget policy. Budget policy cuts right across all of society, and decisions are made by many players. In exchange rate policy, a relatively small handful of people make the decisions.

Senator BAUCUS. As a practical matter how do you get other countries to participate? The other four countries that we are talking about here?

Mr. HUFBAUER. It may be—as one of the earlier interchanges suggested—that while the Japanese and the Germans and the British and the French say they don't like the strong dollar, in fact they may like the strong dollar very much. But right now, we could ride with their rhetoric, which is to bring the dollar down. However, the initial steps would have to be taken by the United States. That wouldn't be so unusual because, in the past, when other countries have had misaligned currencies, our policy has been: get out of the soup yourself. Self-help might have to be the first step.

Senator BAUCUS. You think we may have to go it alone a little bit then?

Mr. HUFBAUER. We could take a very decisive step. The talk of $50 billion Strategic Reserve, correctly played—and Mr. Roosa went through how you would play it—could make a very great deal of difference. The curious thing today is that foreign central banks have so concentrated their external reserves in the dollar. They have about 70 percent of their foreign exchange reserves in the dollar, which is a grossly disproportionate amount, given the size of trade flows. As they saw the dollar weaken, they might very well come along and diversify their reserves.

Senator BAUCUS. Thank you very much.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. Gentlemen, as I understand it, the two of you are in the same position and also Mr. Roosa is in the same position. Is that right? I mean, there may be some little differences between you, but is it essentially the same view that is being taken by both of you and Mr. Roosa?

Mr. HUFBAUER. Absolutely. We may be the only three people whom you could find with this view, and you have got them all together in the same room. [Laughter.]

Mr. PARDEE. There are shades of difference, however.

Senator DANFORTH. But as far as we are concerned, I mean at this stage of our consideration of this matter, it is the same position, and the position is that the exchange rate problem is a very serious problem, that it is badly damaging the trade picture, that it is in the best interests of the United States to reduce the size of the deficit of the Federal budget but that that is not going to do the job of fixing the exchange rate problem, and that the time has come to consider a more interventionist policy, particularly in concert with other countries with respect to relative values of currencies.

Mr. **Hufbauer**. Could I just make one small qualification? It might happen—notwithstanding the statistical and other evidence in my testimony—that correction of the budget deficit would move the dollar down and take care of this episode of misalignment. But I think if we see how the world financial system is likely to develop over the next 10 or 15 years, we must recognize that with movements of capital being so large, other episodes of misalignment of the U.S. dollar and other currencies are very likely to recur, quite apart from what nations do in terms of fiscal discipline. So, there is a longer term problem in addition to the immediate U.S. problem.

Senator **Danforth**. Do you view this as a long, nagging problem or does it have the potential for true disaster?

Mr. **Hufbauer**. It has the potential for true disaster. I think there is a worthwhile debate as to whether the soft landing described by Mr. Pardee is the correct way out or a hard landing. I think a story can be told, which I haven't told in this statement, that the hard landing is, in fact, a better way out, but any way out means pain, and if it becomes a route, it could certainly translate into a disaster.

Mr. **Pardee**. I want to endorse that point, that we could be faced with disaster in either direction. That is, we could have another situation in which the dollar is rising sharply in the exchange market, and the other central banks, the other governments—again perhaps because they are ambiguous in their attitude toward a strong dollar or a weakness of their own currency—may step back. Then, we could have a full-scale run into the dollar away from other currencies, further distorting trade patterns and placing strains on the structure of our trade and financial arrangements. Also, to the extent that it overshoots the dollar is as on a pendulum in the exchange market. The further it swings in one direction the further it will go in the other direction when it swings back. So, the other scenario is the dollar could collapse. I am in the bond market. One of our great fears as bond dealers is the day that we get calls from our European customers to sell 7-year notes, 2-year notes and long bonds. When at the same time, the United States Treasury is offering $20 billion in a refunding. That will be hell on wheels for anybody who is in the bond market. It will be the kind of crisis that Senator Long was talking about. It will occur in the context of a declining dollar, implying a loss of confidence in the dollar and in our bond market.

Senator **Danforth**. If you were in our shoes, would you begin work right now in either addressing the question of legislative remedies or in bringing some pressure on the administration to take the steps that you are recommending?

Mr. **Pardee**. Pressure on the administration is probably sufficient. I can't see legislative remedies. Maybe expressing a sense of Congress might help. It is totally within the power of the administration to change to the type of mechanism I have suggested.

Senator Danforth. Thank you.

The Chairman. Do you foresee any possibility in the scenario you painted about your foreign bond holders saying sell our 7-year's and sell our 2-year's, at the same time Treasury is coming out with a new issue—that you could have no bidder on the Treasury issue?

Mr. Pardee. At a price, we would have a bidder. It is part of our job as primary dealers in U.S. Government securities to make a bid, particularly to good customers that we have worked so hard over the years to develop. It wouldn't be a high bid, however.

The Chairman. Is there a possibility that the Treasury might be surprised at the bid if they wanted to market their $20 or $30 billion in new issues to float the deficit for a month?

Mr. Pardee. That is exactly what I am suggesting—that you could have a much worse market situation than you have had before, given the combination of the size of the offerings by the Treasury and the now very massive holdings of U.S. Treasury securities by private foreign individuals who have no interest necessarily in supporting our market.

The Chairman. Thank you very much.

Mr. Hufbauer. I would like to briefly follow up on that, because I think Mr. Pardee's remarks get to the crux of the soft landing/hard landing scenario. If we adopt policies which regularly ensure that the exchange rate drops, let's say, by 1 to 2 percent a month, then I think it is almost certain that the European holders of bonds will place those phone calls. The interest rate differentials will not be great enough to pay for them to continue to hold U.S. securities as against their exchange rate losses. On the other hand, if the exchange rate abruptly drops by another 10 percent—as it has moved 10 percent this last month—it puts the Europeans and other holders in the position of saying, well, we have taken a capital loss, but maybe the best thing is to continue holding our dollar assets. Then we would not see the sales of bonds by foreigners that would translate into an increase in interest rates. That is the main reason that I see for giving the hard landing story some sympathetic listening.

The Chairman. You are saying that under the hard landing that they have already taken the capital loss so quickly that they will figure we have bottomed out, and there is no point in getting out now.

Mr. Hufbauer. Exactly, Senator.

The Chairman. Senator Bradley?

Senator Bradley. That is an intriguing idea, but that assumes there is a bottom. And you know, if you say hard landing means we will quickly go down to 30 percent versus going down 10 percent for 3 years in a row, you assume it is just going to go down 30 percent, which I don't think you can be sure of, right? It could go down 40 percent.

Mr. Hufbauer. Exactly, Senator, and I think that——

Senator Bradley. So, there is a balance to be looked at here. One is to say proceed cautiously, try to get a soft landing. The other is to say take the big risk, see how far it will go, and we bet the whole system won't be destroyed. Given a choice, I would rather proceed cautiously. Do you agree, Mr. Pardee?

Mr. **Pardee**. There is no bottom.

Senator **Bradley**. There is no bottom?

Mr. **Pardee**. There is no bottom in international financial markets. People will continue to sell and they will borrow to sell.

Senator **Bradley**. So, in other words, tulips could drop by 100 percent.

Mr. **Pardee**. And people will borrow to sell more.

Senator **Bradley**. Now, let me ask you this. I don't know which one of you mentioned that a 10-percent decline can occur in a matter of weeks, 30-percent decline in a matter of months, or 50 percent in a matter of years. It seems to me that the pound kind of increased relative to the dollar about 20 percent in a matter of days. Isn't that a kind of symptom of the kind of instability in the exchange system itself?

Mr. **Pardee**. This was a snapback from an earlier sell off for the pound sterling. The British Goverment decided to raise interest rates to 14 percent. They squeezed the market. They did not intervene much. The German authorities did the opposite thing. They intervened heavily, and they did not tighten monetary policy very much, and their currency also rose by 17 percent. So, it is a question of whether you have your central bank tighten up monetary policy at a risk of jobs, or whether you intervene judiciously to handle the exchange market separately.

Senator **Bradley**. I take it from your answer that you just gave that you don't agree with people in the Treasury who say that the real determinant of foreign capital flows to the United States is the belief in the return on equity and the entrepreneurship of the American economy, that it is within the control of foreign governments, i.e. the central banks, to create an economic circumstance where that foreign capital could flow back to their countries?

Mr. **Pardee**. I agree with the broader philosophy to a point. Many investors that we work with do believe in the United States, believe in our future, are negative about "Eurosclerosis" and similar negative terms.

Senator **Bradley**. But none of them were the people who put their money back over——

Mr. **Pardee**. No, they still have their money here.

Senator **Bradley**. When the interest rate went up. Is that right?

Mr. **Pardee**. Yes. They still have their money here, but it is the people who were the speculators, and there are some very large players in the market, including the Foreign Trade Bank of the Soviet Union, who were taking advantage of the vacuum in the market to push the dollar up. No one else would take on these speculators, and it was up to the central bank, in effect, to be the counterforce.

Senator **Bradley**. What would you say if you were someone who has witnessed this over a period of time as to what percent of that market is speculative and what percent is kind of long-term investors in the stability of America?

Mr. **Pardee**. If you take the year as a whole, the kinds of capital flows that you and I would understand from the economic textbooks amount to some 90 to 95 percent. The other 5 percent is speculative fluff. In a market context, however, when all of a sudden the word gets around the market that the Russian is in buying dollars, then people will buy dollars. The dollar could rise 1 or 2 or 3 percentage points, just in that context, because no one else will stand up and say I will sell $500 million at that point or $300 million, or whatever is necessary to do the trick.

Senator **Bradley**. Are you saying that the Russians play a manipulative role in this speculative element of the exchange rate market? I mean, I didn't realize they were that big a player. I thought the Euro currency markets were fairly big and that they were fairly small.

Mr. **Pardee**. They are very big players. There are a number of other big players, including some European corporations. It is a role that has been played over the years by a number of players, but right now it is what is called the "red man" in the exchange market.

Senator **Bradley**. The what?

Mr. **Pardee**. The red man.

Senator **Bradley**. The red man. Let me ask one other question for your opinion. What would be the effect on the exchange rate if the United States adopted a number of protectionist policies? Let's say we decided to really protect autos, cut back on the amount of foreign imports. Let's say we really decided to protect electronics, cut back on the amount of imports. What would be the effect on the value of the dollar?

Mr. **Pardee**. Probably not much in the immediate term because the exchange traders would expect quick retaliation by other governments. It might lead to some of these speculators being more cautious. The measures might influence the dollar either way. They might actually cause a decline because people have been concerned about the broader effects on the U.S. markets of protectionism. They could also lead to a rise in the dollar on the cutback of imports. In several, they would lead to more instability, I think, because traders would not know which way to jump.

Senator **Bradley**. What do you say, Mr. Hufbauer?

Mr. **Hufbauer**. I say that it is unpredictable as to whether restriction on a particular product or restriction across the board, for example an import surcharge, would cause the exchange rate to appreciate or to depreciate. If you read the textbooks, the exchange rate would appreciate. It is the old trade-driven story which I have recounted in my testimony. But it is quite possible that exchange traders and people around the world will say the United States has just lost control. The United States is giving up on the GATT. The United States is giving up on the world trading system. We had better retreat to the Swiss franc or we had better retreat to gold.

Senator **Bradley**. So, you are saying that you think people might decide that no matter how stable the United States is politically, that they want their money in gold.

Mr. **Hufbauer**. Or whatever.

Senator **Bradley**. If you had a shock to the world trading system, you know, I thought that might lead to a down turn in world trade, which might lead to a deflationary circumstance which is how much is your gold going to appreciate?

Mr. **Hufbauer**. Sure. You are right, it could be wrong to go into gold. I am not saying that gold necessarily goes up. But what I am saying is that one can tell a story in which gold goes up because of great uncertainties about the external economic policy of the United States or the Swiss franc goes up as a haven currency. Equally plausible is the notion that the dollar would go up. People might say that the United States is dealing with its trade deficit. That is a compelling argument for the dollar. At the same time, the United States is dealing with the budget deficit, and that is even more compelling. And so, therefore, foreigners might buy more dollars. The outcome is quite uncertain.

Senator **Moynihan**. If I may interrupt, we still have two very distinguished witnesses. I want to thank this panel. You have given at least this Senator an idea for getting their attention downtime. How do you like this headline: Communist Bankers Out To Destroy American Industry? [Laughter.]

Senator **Bradley**. We will call them Communists, not reds. [Laughter.]

Senator **Moynihan**. We thank you both very much, gentlemen. And now for our two concluding witnesses this morning. We have the great honor to have Mr. John Leddy, who is one of the architects of the American postwar trade policy—exactly that policy which Mr. Hufbauer suggested people might be concluding would be abandoned if we were to move in the direction that Senator Bradley speculated about—and Mr. Robert Best of Allen-Best Associates. Mr. Leddy, we welcome you back to this committee.

STATEMENT OF JOHN M. LEDDY, FORMER COMMERCIAL POLICY ADVISOR, DEPARTMENT OF STATE, WASHINGTON, DC

Mr. **Leddy**. Mr. Chairman, it is a great pleasure and privilege to be here. I must say you are addressing a very, very important subject, and I just hope that this committee can find a way out of the mess we are in. I think, as you know, I have been asked to testify on a fairly simple historical point, which might be of interest to the members of the committee. And that point is this: What did the American trade negotiators—not the financial people—the monetary side was at this time in the hands of the Treasury exclusively—but what did the trade people on the American side do when they were negotiating the GATT and preparing for it, what did they have in mind about the future of the exchange rate system? I can tell you that they were very conscious of the close link between the exchange rate and the trade barrier problem. The primary concern which they had in mind, unlike today, their primary concern was the fear that currency devaluation would be deliberately used by nations as a means of pushing out exports and restricting imports; a kind of beggar-thy-neighbor policy. You see, I am now talking about the period from about 1943 to 1947. The beginning trade talks started in 1943, and the GATT was concluded in Geneva in 1947. And the leaders of the American team—Will Clayton, Harry Hawkins, and Clair Wilcox are no longer with us—but all of this was in their minds, and they also recalled the period of the 1930's and in particular the London Economic Conference of 1933 which illustrated this connection in a very vivid, sharp way. The United States had raised its tariffs to an all-time high in the Tariff Act of 1930. The British had, in 1932, increased their tariff and intensified imperial preference, damaging American exports throughout the

Empire. And you had retaliation against the United States worldwide, and world trade and finance was in a shambles. So, the London Economic Conference of 1933 was called to see whether something could be put together, whether you could call a standstill to trade barrier rises, and then began to push them down. But the key point was would there be a stabilization of currencies. None of the countries were willing to go ahead in reducing trade barriers unless you could have a stabilized currency system. And this issue then came to President Roosevelt. He temporized with that for a while. There was a period—if anyone is interested, they ought to read Dean Achison's "Morning and Noon," which is an account of it from the fellow who was on the inside of this byplay—but Roosevelt finally decided that we could not agree to stabilize the dollar because he wanted to use it to raise prices, a devaluation in effect, which was just what foreign nations were concerned about. And when the message came to the Conference, that collapsed the London Economic Conference of 1933. And I think the lesson is clear that there is a linkage here. I had spent a little time with Bob Roosa in the Treasury some years ago, and I was fascinated with his discussion here today. I have always regarded him as a kind of a genius in this field. I would only quarrel with one or two points that he made about the import surcharge, but nevertheless, thanks very much for having me here, and I hope I have contributed a little historical enlightenment if you didn't already have it.

Senator MOYNIHAN. Mr. Leddy, if my colleagues would permit me to say it, I was a student of Harry Hawkins, and I remember with great vividness his sense of exactly what you are saying. Competitive devaluation, and beggar-thy-neighbor policies, were the great sin in the 1930's. And those men were not talking about something that led to a 3-percent decline in the standard of living. They were talking about something which in their view led to the Second World War. It led to Bergen-Belsen. It led to Hiroshima. It led to a lot of things that we would just as soon have not have happened. Now, Mr. Best?

[Mr. Leddy's prepared statement follows:]

STATEMENT OF JOHN M. LEDDY, FORMER ASSISTANT SECRETARY OF STATE AND TREASURY AND AMBASSADOR TO THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT

Mr. Chairman, I am here to testify on a single point: the assumptions held by the original negotiators of the General Agreement on Tariffs and Trade (GATT) regarding the stability of international exchange rates in the postwar period. I was a State Department commercial policy advisor and a member of the American team that formulated proposals for and negotiated the GATT and the International Trade Organization (ITO) during the years 1943-1948. The leaders of the American team, notably Will Clayton, Harry C. Hawkins (principal trade adviser to Cordell Hull) and Clair Wilcox, are no longer with us. I will do my best to reflect what I believe to have been the thinking of the American trade team about the relationship between exchange rate policy and trade liberalization. Here I must emphasize that in the United States monetary policy was virtually exclusively in the hands of the Treasury Department, which controlled the negotiation of the Bretton Woods Agreements.

It is safe to say that the American trade negotiators of GATT were deeply conscious of the exchange-rate problem. A major concern was the fear that exchange rates, notably competitive devaluations, would, as they had in the 1930's, be used to deliberately stimulate exports and reduce imports at the expense of other countries. A beggar-thy-neighbor policy, in short. The American negotiators were also well aware that the London Economic Conference of 1933 had collapsed because of the exchange-rate problem. At the time world trade and finance were a shambles: the Smoot-Hawley Tariff of 1930 had led to world-wide retaliation. England greatly increased its tariffs and intensified the imperial preference system. Exchange controls, barter agreements and restrictions of all kinds were on the rise. A purpose of the London Conference of 1933 was to call a halt to rising trade barriers and proceed to roll them back. To achieve this, however, the conferees considered it essential to stabilize the exchange rate system. When President Roosevelt sent his message to the Conference that the U.S. would be unwilling to enter international commitments to stabilize the dollar exchange rate (expressed in gold), the Conference collapsed. Dean Acheson's book "Morning and Noon" well describes how the U.S. decision on this critical issue was made.

Returning to the GATT negotiations, international trade talks between the United States, the United Kingdom and Canada began in 1943 but did not enter the stage of serious negotiation until 1945. The GATT negotiations, on a wide multilateral basis, began in 1946 and concluded in 1947. Meanwhile Bretton Woods had taken place in 1944, the International Monetary Fund was an accomplished fact and all of the trade negotiators knew that the future monetary system would be a cooperative one with exchange rates based on established par values which could be adjusted from time to time through IMF procedures.

In sum, the American trade negotiators of the GATT were concerned about the exchange rate problem and conducted their negotiations in the assurance that this problem would be properly managed through the IMF.

STATEMENT OF ROBERT A. BEST, PRESIDENT, ALLEN-BEST ASSOCIATES, LTD., WASHINGTON, DC

Mr. Best. Thank you, Senator. While I don't go quite as far back as John Leddy or Bob Roosa, I must say this is a bit like home week. After graduate school, my first job was with the Treasury under Bob Roosa and his then-deputy Paul Volcker. Subsequent to that educational experience, I spent 12 years with this committee, which was the most valuable and cherished experience of my life.

Mr. Chairman, I have to commend you for the questions that were asked in the press release. They really indicate that you cannot deal with these issues, which form a kind of a seamless garment, as if they were hermetically sealed in separate containers. Indeed, domestic fiscal and monetary policies are interrelated and have international consequences, and you can't totally separate trade policy from international monetary policy.

I also want to commend the staff for the document they produced, which not only gives a historical perspective on the problem, but points out the paradoxes. I noticed on page 18 of your staff document, that the yen has appreciated with respect to the dollar some 25 percent since 1980, and later on on page 25, there is a statistic indicating that the U.S. competitiveness has declined 28 percent, all while we are experiencing $30 to $40 billion bilateral trade deficits with Japan. That is not explained in the textbooks under any theory that I know of under a flexible exchange rate system.

Let me just spend the last minute or two discussing what I believe to be the fundamental solutions. I don't think there is any single solution. I do believe that we have to get down to the fundamentals, and that includes dealing with the U.S. domestic deficits. After all is done on the expenditure side, I think this committee is going to be faced with a decision on taxes. And I would suggest that maybe some useful time could be spent deciding if we are going to have a tax increase, what should be the nature of it? My own preference would be some kind of a consumption tax, be it a value added or Btu or some tax of that kind.

The summit offers a great opportunity to set in motion a process that relates international monetary issues to trade issues. Some day soon we will realize that the alternative to a realignment in currencies is, in fact, a surcharge. I believe that the "great power" may come to recognize that unless there were to be a sort of "great power agreement" relating the monetary and trade issues that the United States will ultimately be forced by the nature of the problem to adopt some kind of surcharge, which would be in effect a substitute for a currency realignment—a very poor one, I believe, but the political reality of the situation will push us in that direction. Thus, I agree with Bob Roosa about moving toward a flexible band system. He has a better name for it, but it would essentially target currencies within a band and allow the band to move. The underlying support for that would be a more regular system of cooperation and coordination by the monetary authorities—the central banks—internationally.

With regard to commerical policy, the United States should adopt a commercial policy that eliminates forever the kind of dropping of the lead ball on our foot which we engaged in a number of times in the 1970's. For example, in 1973, we embargoed the export of soybeans. You couldn't do a more damaging thing in your relationship with Japan than to deny a basic ingredient of their food supply. And later on, in the late 1970's, we embargoed the export of Alaskan oil to Japan. Now we are trying desperately to sell them coal, which unfortunately they are buying from Canada, Australia, South Africa, and the People's Republic of China. I don't think we can engage in a unilateral embargoing of exports—and be arguing constantly that we have to have greater market access in Japan. I think we are at sixes and sevens on that. On the other hand, as I indicated in my statement, Japan's great trading companies, in their own self-interest, ought to be giving "preferential treatment" to the goods made in the nation whose market absorbs the bulk of their exports—the U.S.A.—particularly during times when the overall bilateral relationship is so one-sided. I see the red light has gone on, and I always try to be observant of this committee's rules.

The CHAIRMAN. You are very generous. Thank you.

[Mr. Best's prepared statement follows:]

PREPARED STATEMENT OF ROBERT A. BEST, PRESIDENT, ALLEN-BEST ASSOCIATES, LTD.

Mr. Chairman, and distinguished Members of the Committee, I sincerely appreciate this opportunity to appear once again before you. As many of you know, I am a creature of the Congress and of this Committee, having spent more than a decade serving on your staff. It was an experience that I will always cherish.

The issues which you outlined in your Press Release of April 5 are familiar to many of us who have specialized in—some would say made a career out of—balance of trade and payments issues. Mr. Chairman, you asked the question of why the American dollar has appreciated in spite of the vast current account deficit. It is obvious that the real world does not follow the theories we learned in Economics 101 or even the more sophisticated graduate courses we may have had. I believe the American dollar is strong because of: (a) high real interest rates in the U.S. and the real differentials with other currency assets; (b) a stable political climate, particularly when compared with the alternatives; (c) undervalued equities; and (d) favorable long-term growth prospects. Simply put, where would you rather invest capital?

On the question of whether a free and open market for dollars, unfettered by government regulation is, in fact, compatible with a free and open market in traded goods, I believe the answer is yes, but. The "but" presupposes greater coordination of domestic monetary and fiscal policies, internally and externally. Otherwise, the exchange rate relationships will be out of line with the underlying realities as I believe they are in the dollar-yen case, and the structural trade imbalances will result in increased trade restrictions, as has been the case since 1971. On the other hand, I can't see the world returning to a rigid fixed-rate system with the full adjustments falling on the deficit nations.

As you may recall, before the break with the fixed-rate system in 1971, the deficit nations such as the United States had to "protect" their foreign exchange reserves and limited gold supplies by actions which were sometimes silly and other times worse. Thus, during the Sixties, we erected barriers (exchange controls to direct and portfolio investments abroad, even to bank loans; we penalized American tourists, even thinking seriously of imposing a very stiff tax on foreign travel, and engaged in strenuous efforts to force NATO allies to buy medium term bonds—all in the name of correcting the balance of payments and preventing DeGaulle from cashing in French held dollars for American gold. If we had a rigid fixed-rate system now, there would be a veritable wall or barriers around America. Some see a magic alchemy in the gold standard, but I can't believe we would accept the arbitary external discipline of that system if we abjure the internal discipline of our own budget process.

There may well be a need for greater, more deliberate and more frequent intervention in the foreign exchange markets. At one stage, I believed that currencies should be allowed to fluctuate freely with a band, and that once they reached or approached the limits, Central Banks should intervene in the foreign exchange markets. That kind of flexibility is not inconsistent with moving pegs, as they were called by the international monetary gurus. I would like to hear Chairman Volcker's views on this subject. I knew him from his early days in Treasury in the Kennedy and Nixon Administrations. One must have enormous respect for his accumulated wisdom and experience. He is more qualified to express a judgment on where we go from here, but I also suspect he is less free, as the markets heave on his every sigh.

History has a way of repeating itself and there are "disquieting similarities" between this period—marked by huge international indebtedness, liquidity problems, high real interest rates, structural trade disequilibria, and pressures for sweeping protectionism for "basic industries"—and the turbulent thirties. I think we learned a lot since those days and I am not really concerned that the Congress would pass another Smoot-Hawley tariff or that any President would sign such a bill. But I am concerned that the lack of coordination between international monetary policy and trade policy (similar to the lack of effective coordination between domestic monetary and fiscal policies) could strain the "system" to its limits, ultimately leading to a rupture in the fabric of international cooperation.

Trade policy cannot be neatly isolated from exchange rates or a stable long-term monetary and fiscal policy, one which is growth oriented and not on-again, off-again. In a very real sense, trade in goods and services internationally is a byproduct of a healthy domestic economy, sustained, if you will, by sound monetary and fiscal policies. Unfortunately, for most of the post-war period we have suffered the consequences of an overly expansive fiscal policy and an overly stringent monetary policy. In recent years, the dimensions of this asymmetry have become enormous and unsustainable.

The Congress is once again in the middle of its budget process. One can only hope that the cuts contemplated are real and not illusory and that a bipartisan agreement can be reached on a long-term reduction in the size of the deficit in relation to the size of the economy and that expenditures will be reduced in relation to the GNP. Ultimately, a sound macro-economic policy is the best trade policy. In that connection, however, if at the end of the day, after all the expenditures have been reduced to a level politically acceptable, there is still a significant "full employment deficit," some increase in revenues will be required. At that stage, instead of increasing taxes on labor or capital, serious consideration should be given to some form of consumption tax, either a value-added (call it some other name) or a BTU tax or an import fee on energy. Another increase in the gasoline excise tax should not ruled out. The import surcharge idea should be considered only as a trade measure to substitute for a much needed realignment in the yen-dollar relationship if that realignment is not agreed to through international monetary cooperation.

The recent agreement to discuss monetary as well as trade issues at the Summit offers a wonderful opportunity to begin to attack the underlying causes of the structural imbalances in the world economy and particularly between the United States and Japan. We may have accidentally stumbled into something with brilliance, or brilliantly married a U.S.-French divergence. But it does not matter as long as there is an understanding that if the exchange rates are not realigned in a cooperative manner, the pressures for a surcharge will not disappear with the latest package of trade openers from Tokyo. No one should be under any illusion that a package on telecommunications, drugs, wood products and computers, as desirable as these market openers are, will change the fundamental disequilibria in the U.S.-Japan trade relationship. More fundamental macro-economic policy changes in both nations are necessary, coupled with a realignment in the currency parities. If we do not address the fundamentals, the overall U.S.-Japan relationship will deteriorate dangerously. The frustrations in Congress have already reached a level in which "Japan bashing" could become more fashionable than "budget busting."

A great nation has the will to do whatever is right, whatever is necessary, whatever is appropriate to resolve its own problems, and not be in the position of either begging thy neighbor or beggaring thy neighbor. As elected representatives, Members of Congress are currently under severe pressure from constituents suffering the consequences of macro-economic disorders with macro-economic complaints. This does not make the complaints less real, or less valid, but the pressures would be a lot less if the fundamentals in the relationship were addressed and corrected.

I am not here to suggest that the trade problems be swept under the rug while these macro-economic issues are addressed. On the contrary, Japan for its own sake must open its markets in very specific ways and I would argue do more than that; they must sincerely embark on a "Buy American" crusade in areas in which we are competitive.

In addition to the four product areas which have received so much attention, Japan should make a major investment in American coal and other resources which they need, and further, should adopt a long-term investment strategy in which their management skills and capital are "married to" those of American corporations to enhance jobs and consumer choices on both sides of the Pacific. The recently announced joint venture between Mitsubishi and Chrysler in which a shared commitment of capital and production was made for a plant in the U.S.A., is in both nations' interests.

In the end, these joint ventures could do more for American competitiveness and the "two way street" than so called "voluntary restraint" agreements which are neither very voluntary nor often very restraining, but which cost the American consumer without helping the American Treasury. The VRA in automobiles was tantamount to imposing a tax on the American consumer of between 10 and 15% and then sending the proceeds to the Japanese and American automobile dealers and manufacturers. That's not very smart commercial strategy. If we are going to protect an industry, we should do it openly, under the rules, and at least transfer the costs from the consumer to our own Treasury, which needs the money.

Mr. Chairman and members of the Committee, this ends my prepared testimony. I would like to append to it, for your Record, a summary of a paper I did during the great debate over Reciprocity legislation in 1983. The issues have not really changed very much, but the magnitude of the challenge has. Thank you very much and I would be happy to try and answer any questions you may have.

TRADE LAW AUTHORITY AND POLICY

The President is currently empowered with considerable authority in the trade field. The current exercise in the Congress over "reciprocity" legislation is an attempt to give direction to, and encourage the use of, that authority. It is my view that the President ought to define his policy clearly and take certain initiatives to take the steam out of a potentially dangerous legislative directive.

Let me first define the existing authorities and then suggest some principles and initiatives. It should be kept in mind that trade problems are often reflections of general economic problems, managerial mistakes, lack of R & D effort and other causes. Remedies for trade problems are often not embodied in trade law as such.

I. CURRENT PRESIDENTIAL TRADE AUTHORITIES

A. Negotiating authority

1. *Nontariff Barriers Negotiating Authority.*—Under section 102 (b) of the Trade Act of 1974, extended by 1101 of the Trade Act of 1979, the President is empowered to "enter into trade agreements with foreign countries or instrumentalities providing for the harmonization, reduction, or elimination of such barriers. . . ." This authority was extended for 13 years by the 1979 Act. Agreements reached under it would be subject to a fast tract, no amendment procedure under section 151 of the 1974 Act.

2. *Bilateral Trade Agreements.*—Section 106 of the Trade Act of 1974 enables the President to enter into bilaterial trade agreements whenever he determines such agreements will "more effectively promote the economic growth of, and field employment in, the U.S." Such agreements shall provide for "mutually advantageous economic benefits".

B. Balance of payments authority (title I, section 122)

The 1974 Act directs the President to proclaim, for a period of up to 150 days, such import surcharges (up to 15 percent ad valorem) or, under certain circumstances, import quotas, or a combination of the two, as may be necessary to deal with large and serious U.S. balance of payments deficits, to prevent an imminent and significant depreciation of the dollar, or to cooperate with other countries in correcting international balance of payments disequilibria. If the President fails to take action to protect the United States from continuing, large and serious balance of payments deficits, he is required to consult with the members of the Committee on Finance and the Committee on Ways and Means. Import restrictions are to be applied on a nondiscriminatory basis, unless the President determines that circumstances warrant restrictions on imports from individual countries. Such circumstances could include situations in which the large and serious U.S. balance-of-payments deficits are substantially the result of one or several countries having large surpluses and failing to take voluntary and effective action to reduce those surpluses.

C. Compensation authority

The 1974 Act provides permanent authority following expiration of the basic tariff reduction authority for the President to compensate foreign countries for increasing trade restrictions as import relief through new trade agreement concessions. Tariff reductions cannot exceed 30 percent. The President has discretionary authority not to grant compensation to a foreign country which has violated trade concessions to the United States without paying adequate compensation.

D. National security provisions

Section 232 of the Trade Expansion Act of 1962, as amended, by section 127 of the Trade Act of 1974 provides Presidential authority to withhold concessions, or to impose import restrictions whenever the President (after an investigation by the Secretary of the Treasury in consultation with Secretary of Defense, Secretary of Commerce and other appropriate officials) determines imports are impairing the national security.

E. Retaliatory authority

Section 301 of the Trade Act of 1974, amended by 901 of the 1979 Act, provides the President with broad authority to retaliate against foreign countries which impose "unjustifiable or unreasonable restrictions against U.S. commerce". A complaint procedure was provided in the 1974 Act and modified in the 1979 Act under which the USTR would conduct public hearings of such alleged practices and report to the President and the Congress on the findings. The President may and, in fact, is encouraged to retaliate *on a selective basis*, e.g. only against the goods of the offending country, and can also use this authority against countries which withhold supplies of needed commodities without justification.

II. AUTHORITY UNDER IMPORT RELIEF PROVISIONS

A. Escape clause

Under section 201 of the Trade Act of 1974, if after a complaint is filed, hearings are conducted and a full investigation is made, the International Trade Commission (USITC) finds that imports are "a substantial cause of serious injury" (or threat thereof) to an industry, the President *may* provide import relief (duty increases, tariff-rate quotas, quotas, orderly marketing agreements.) This general escape clause provision has been a part of the trade agreements program since its inception in 1934. In recent years, while the petitions have grown, the relief has dwindled.

B. Antidumping

Under Section 321 of Trade Act of 1974, as modified by section 733 of the 1979 Act, the administering authority (now Dept. of Commerce) determines whether imports are being sold or offered "at less than fair value" in the U.S. The USITC must determine whether such "dumped" imports are causing, or threatening to cause, material injury. If both findings are positive an antidumping duty is proclaimed. This can be waived if "dumping" practices stop.

C. Countervailing Duty

Section 331 of the 1974 Act, modified by Title I of the 1979 Act, provides authority to impose special duties to "countervail" foreign subsidy practices. In the original legislation (Section 303 of 1930 Tariff Act) subsidy was broadly defined to mean a "bounty or grant" on "the production, manufacture or exportation" of any commodity grown or manufactured etc. Numerous court cases have tried to interpret the legislative history in defining the meaning of bounty or grant. It still remains a sticky wicket. Nevertheless, cvd procedures have been instigated more frequently in recent years, particularly by the U.S. Steel industry and have led to "trigger price mechanisms" and other trade distorting devices.

Having described above existing U.S. trade authorities, the major issue remains: What should be our trade policy and how should we, as a nation, deal with particular imbalances with major trading nations when such imbalances contribute in a significant way to economic dislocations.

It is generally agreed that an open, nondiscriminatory trading system is the goal, the ideal, for trade policy to aim at. It is also widely recognized that this is not, in fact, the practice. That being the case the question is: "should we depart from the goal because it is not universally, or even predominantly, practiced by major trading nations? I have reached some conclusions:

(a) The United States must use the authorities it now has to "push", "cajole" or if you will "force", other major trading nations in the direction of the goal of an open competitive trading system.

(b) This will be a process that involves bilateral as well as multilateral negotiations.

(c) Such negotiations will succeed only if the Executive and Legislative branches agree on trade policy and work together to implement it.

(d) Since "trade problems", as indicated previously, are often a reflection of non trade causes (exchange rates, management mistakes, low R & D efforts, "lousy products" etc.), the remedies, if any, for such problems often lie outside of the trade policy arena.

(e) Government's role is to assure that competitive conditions exist in the market place, not to provide import relief to those who cannot compete.

(f) A major exception to (e) lies in the national defense-security area where nations with major responsibilities for maintaining the peace must assure themselves of the means to assume those responsibilities.

Having said all of the above, what, if anything, should the United States do, unilaterally, bilaterally and multilaterally.

Unilaterally, one can make the case that the United States must do the following:

(a) Restore a sustainable period of noninflationary economic growth by eliminating "structural" budget deficits, and excessively high real rates of interest.

(b) Move toward a greater emphasis on consumption and user taxes and away from taxes on income and profits.

(c) Provide industry with the tools to compete in the international marketplace.

Bilaterally, the United States should:

(a) Negotiate for "equitable", "reciprocal" "overall" market opportunities in trade and investment with trading partners.

(b) Withhold, or terminate, if necessary trade and other concessions and benefits from nations which refuse, after adequate negotiations, to provide for such opportunities.

Multilaterally, the United States should:

(a) Insure a proper coordination of monetary and fiscal policies among major trading nations.

(b) Insist on "rules of the game" embodied in international agreements that are consistent with principles of open competitive markets; adequate and enforceable dispute settlement mechanisms; and agreement not to provide "free rides" to those in stages of development which would enable them to compete on equal terms.

TRADE AND ECONOMIC POLICY OPTIONS

If one accepts the above principles as guidance for U.S. policy, the following measures could be considered as appropriate responses to U.S. economic and trade dilemmas. They require study and comment before they could be put forward as a comprehensive response to the problem(s) facing the U.S. with projected triple digit "structural" budget deficits and double digit "structural" trade deficits.

TAX MEASURES

The United States should consider applying a value added tax on consumption (and imports) of goods and services. Such a tax could be phased in at say, 2 percentage points a year until a maximum of 10% is reached. At the same time the social security employee "contribution" could be gradually reduced to no more than 5% of income (from projected levies of 7.5%) and the corporate tax rate reduced to a maximum of 33%. DISC could be repealed along with other special provisions.

Half of the revenues generated by the VAT could be earmarked for the social security program: the other half to be channeled into a Reconstruction Finance Corporation, incorporated within the Department of Treasury or Commerce. The latter would be targeted to assist industries facing severe competitive problems.

TRADE OPTIONS

The President has ample authorities described in the first part of this paper to negotiate bilaterally and multilaterally for the removal of trade distortions and barriers against U.S. exports. He also has authority to take unilateral actions for national security, balance of payments or "retaliatory" reasons.

The Danforth bill is primarily aimed at providing a direction for the use of these authorities, the direction being "equal competitive opportunities." It is implied in the so-called "reciprocity" legislation that if equal competitive opportunities do not result negotiations the President should exercise his authorities to achieve such conditions, unilaterally.

The Williamsburg Summit offers an opportunity to agree on certain basic principles and to set in motion the bureacratic machinery needed to implement such principles. If this opportunity is lost, Congress will be tempted to pass legislation at best aimed at "forcing" a solution and, at worst, implementing a solution such as "local content", "buy American" and other measures supported by certain industry and labor groups and coalitions.

In addition to the Williamsburg Summit opportunity, the President could take a number of measures which would alleviate U.S. trade problems immediately and offer hope to industries and workers beset by import-related problems.

Among the short term measures the President could take which would be consistent with open and nondiscriminatory trading systems would be:

(1) Directing his Special Trade Representative to prepare a plan for negotiating the elimination of trade distorting devices.

(2) Greatly expanding the guarantee authority of the Export Import Bank without changing the criteria of "reasonable assurance of repayment".

(3) Asking Congress once again to modify the Foreign Corrupt Practices Act and other unilateral impediments to exports.

(4) Making the "enterprize zone" assistance available to communities hard hit by imports.

(5) Provide special tax advantages for retraining of displaced workers.

If he wants to go further the President could:

(1) Direct the Secretary of Defense together with other appropriate agencies to prepare a report on the industries considered critical to U.S. defense requirements and to determine whether imports on these areas are threatening to impair the national security.

(2) Direct the Secretary of Treasury to prepare a report on establishing a "Reconstruction Finance Corporation: to assist industries in modernizing plant and equipment and adopting management and marketing techniques to meet foreign competition.

(3) The Secretary should also be directed to prepare a study of our tax laws, including the options of:

(a) A flat tax for individuals and corporations.

(b) A value added tax as a substitute for certain income and payroll taxes.

(c) A national security tax on oil imports under section 232 of Trade Expansion Act of 1962. (See Safire article attached)

There are more drastic actions that could be taken unilaterally such as exercising retaliatory authority under section 301 against goods from countries which refuse to negotiate in good faith; exercising balance of payments authority under section 122 of the 1974 Act. However, these would likely lead to retaliation against American exports and are therefore undesirable except in emergency situations.

Mr. BEST. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, because you were necessarily out of the room, is the budget decided?

The CHAIRMAN. The budget is decided. You don't need to worry. We will pass it about 3 this afternoon.

Senator MOYNIHAN. About 3 this afternoon? All right. Now you see what can be done when we put our minds to it. [Laughter.]

John Leddy was telling us in great detail of the origin of the GATT. It was very much a concern of our negotiators, based on American policy, that there be stable exchange rates. In the 1930's, countries devalued their currencies as a trade device, exporting their unemployment. And President Roosevelt was trying to raise prices and wouldn't let that go. I guess that is why Dean Achison resigned, wasn't it?

Mr. LEDDY. Yes; he resigned on the legal issue of the President's power to fix the gold content of the dollar. He thought it was strictly illegal, and he would not take the responsibility for it.

Senator MOYNIHAN. And at the same time the President would not take the responsibility for a world economic system and the only point I would like to make, Mr. Chairman, is that when you think back on the origins of American trade policy and the State Department, and I am sure John Leddy would agree and Mr. Best would agree, those people weren't just trying to put together a more efficient world economic corporation or some system arrangement whereby growth would be 2.9 percent a year instead of 2.7 percent. They were looking at events in their immediate past which they reasoned had led the world to the most horrible encounter with violence and savagery it has ever known—by that I mean the Second World War—which very much came out of the succession of economic decisions, bad decision in the West, that had led one way or another to that war. And it was a lot more than a standard of living they were talking about. They were talking about life. And if we let the United States lose its industry, which we have been hearing about from the chairman and others, then an awful lot that the United States stands for loses standing in the process. And this goes over into the most profound politics of the international order. At least, I think that was your judgment, wasn't it, Mr. Leddy?

Mr. LEDDY. Yes, it was.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Mr. Leddy, I am not quite certain as to what the London conferees were thinking in 1944. I heard you say that they were worried that countries might engage in competitive devaluations to encourage exports. My question is: Did those conferees think that the IMF would take care of this exchange rate problem?

Mr. LEDDY. The IMF, which was agreed upon in 1944, provided for a system—an adjustable par value system in which countries would first set their currencies in the Fund and then not change the par value without the consent of the Fund. So, this provided a stable exchange rate system. Of course, for many years you know, you had balance of payments restrictions on throughout the rest of the industrialized world, except for Canada and ourselves—and until currencies became convertible—then of course, the restrictions were all dropped. And since the convertibility of currencies, started actually in 1961—I remember it extremely well—I was in the Treasury at that point as an Assistant Secretary working with Bob Roosa—and we were greatly concerned because of the balance-of-payments deficit. At that time, we used to measure the balance of payments by what was called the overall deficit. We didn't focus on the trade deficit but the overall deficit, which began to rise in 1958–59, and 1960.

Senator **BAUCUS**. Should the next GATT round address this problem?

Mr. **LEDDY**. GATT has provisions in it permitting balance-of-payments quotas. When a country is in balance-of-payments difficulties, they have to accept the judgment of the Fund on all of the facts in the case and so forth before they can put on quotas, under the circumstances.

Senator **BAUCUS**. You don't think that the next round should address the problem of the volatility of exchange rates?

Mr. **LEDDY**. The contracting parties to the GATT have addressed the problem. They are very much concerned about the volatility of the exchange rates, and in fact, they—through the GATT—started the Fund on a study of the effect of the volatility of exchange rates on trade. And it is my understanding that the Fund has produced a report on that, which I think you should get.

Senator **BAUCUS**. What about the Bonn summit? To what degree should the Bonn summit address this?

Mr. **LEDDY**. One of the problems that I have, sir, is that the first thing that needs to be done about the problem we are facing is for the executive branch to recognize that there is a problem. And until the recent statements of the new Secretary of the Treasury, I did not have that impression.

Senator **BAUCUS**. I agree with you. Some call it benign neglect. I think it is more in the nature of malign neglect.

Mr. **LEDDY**. All right.

Senator **BAUCUS**. But putting that aside, assuming you have the President's ear, and the President would do whatever you wanted him to do, what would you suggest to him?

Mr. **LEDDY**. If I were the President, I would agree with the other members who will be at that Summit that something had to be done about the American budget deficit and that he should be more flexible on the ways he is going to handle it and be bolder in the way he is going to reduce the budget. Frankly, I think he should agree to do more than we have been doing in the way of cooperation in the financial markets along the lines that Bob Roosa was talking about. We have been very "stand-offish" on this, and I see no reason for it.

Senator **BAUCUS**. All right. Thank you.

The Chairman. Senator Bradley?

Senator **BRADLEY**. Thank you, Mr. Chairman. Let me say to both of you, and particularly to Mr. Leddy, how important it is for you to give the committee some historical perspective because frequently we not only lack that but despair for a solution to a problem that we think has never been dealt with before. So, I think that it is very helpful. Let me ask you: As you said, Mr. Leddy, the GATT system as it was originally constituted assumed the stable exchange rate regime. That worked for a number of years and finally, in 1971, although there was erosion, as you pointed out in the 1960's and 1971, we went to floating exchange rates. Some argue that the genie is already out of that bottle. So how do we get it back in? Mr. Roosa said that we should have a group of five with a kind of flexible band, a willingness to intervene and harmonize our macroeconomic policies. Let me ask you: If you could get back to a system of fixed exchange rates, would you prefer that, with all that implies as to what capital flows mean for differential inflation rates, or would you like to try to cope with the present system with all it implies on differential exchange rates?

Mr. **Leddy**. I would have to say that I don't think you can get back to a fixed adjustable par value system as it was in the Fund. I don't believe that anyone ever understood what would happen under the floating rate system or anticipate it. What would happen with this magnitude of capital flow? The monetary fund, interestingly enough, permits controls to be put over capital flow, but so far as I know, no one has ever been able to devise a method of doing that that would be wise and judicious. This is why I was interested in Bob Roosa's presentation because he seemed to be thinking about some way of influencing capital flows without some sort of direct governmental control over the problem. I honestly don't know what the answer to these problems is, but I think that we ought to focus first on the dollar problem instead of the general problem of volatility. I would start with the U.S. dollar problem, and I would start in the United States. What is the cause of the tremendous demand that creates a capital inflow? And no matter where I start, I always come right back to that $200 billion plus budget deficit. I just don't seem to be able to escape it, no matter what I listen to.

Senator **Bradley**. Do both of you agree with Mr. Roosa, though, when I put the question to him about reducing the budget deficit, a willingness to intervene in the exchange markets, and an effort to try to lighten the burden of Third World debt? Do you agree that to the extent we did all three, each one could be less severe?

Mr. **Leddy**. I wouldn't know how to answer that. I don't know what proportions of the three—the only thing I would say is that the most important of those three is the budget deficit. So, I don't know whether you could, by not doing anything about the budget deficit, equalize that by doing more about the other two. I would doubt it very much. I don't see how you can do anything without dealing with the budget deficit.

Senator **Bradley**. Mr. Best?

Mr. **Best**. Yes, I would agree with Bob Roosa. I believe the priorities are: first, a reduction in the structural domestic deficits, second, the reduction in the external account deficit, and I believe that can be best done through a currency realignment. And the international debt problem is bigger than I can handle at this point. I do believe you had better concentrate on two or three countries and perhaps those in this hemisphere.

Senator **Bradley**. The position taken by this administration has not only been that it wouldn't intervene in any exchange rate markets but the international debt problem is too big for them to consider. So, are you saying that governments no longer can attempt to structure things to suit the ends that they have chosen to pursue? I mean, is this totally out of control? I think that is a logical conclusion to the statement that I prefer not to think about this, or I can't do anything about it.

Mr. **Best**. I don't believe that it is an impossible problem. As a matter of fact, Mexico is a lot better off now than they were 2 years ago. I just don't follow it closely enough to know whether stretching out the debt, providing some type of government guarantees on the debt, or having a larger IMF fund, or all of the above, would be the most appropriate measures. I am not a man who believes in benign neglect if there is a problem—but on the other hand, I don't want to bail out the bankers for making bad loans if they made bad loans because that is when you take out all the discipline from the system completely. So, that is the reason for my hesitancy about giving some type of simple formula solution on the debt problem.

Senator **Bradley**. Would you agree that we are at a point now similar to times in history when our economy exploded? When speculative excess reached a point where there was a crack in the system. It happened in the 1930's. It happened in the 1870's. It happened in the 1830's. You know, it is perhaps a characteristic of capitalist economies that this sometimes develops. Now, we put a lot of safety measures in in the 1930's to try to deal with that. We structured the international system after World War II to try to deal with that. And the real question is: Is the genie out of the bottle now so that you are not going to be able to prevent this kind of collapse? And it seems to me that what the administration is saying is: Look, we can earn our way out of this, which seems to me to be an abdication of responsibility. And I hear you gentlemen saying: Look, you can do something about it—you are on the brink, but you are not over the brink. You can cut back on the deficit. You have got to have some selective intervention policies, and if you can figure out a way, you have to find some way of reducing the burden on some of those Third World countries. Is that correct?

Mr. **Leddy**. If you are asking me, I would say the governments—the major governments—can't afford to allow this system to collapse. They just can't do it and they won't do it. I mean, when it gets to the point where it becomes politically essential to act, I am confident that they are not going to allow the trade and financial systems of the whole world to go down the drain. So, something will be done, but a beginning has to be made, and a beginning has to be made by the United States. There is no way around it. I know that we are no longer as dominant as we were in the immediate post-war period, but we are still far and away the largest economy in the free market world and in the monetary field. You can't consider the European Community as one, you know, in the monetary field. These are separate states really, despite the fact that they have a stake there in the money market. So, we are a dominant economy and we have got to exert some leadership, and I don't think we have.

Mr. **Best**. Yes. I am relatively optimistic despite the overhang problem. You know, we have been through a lot of these things in similar circumstances. I remember there was a speech by——

Senator **Bradley**. In similar circumstances?

Mr. BEST. William McChesney Martin made a speech—I believe in the mid-1960's—in which he talked about "disquieting similarities" between the situation that then existed and the situation in the twenties and early thirties.

Senator BRADLEY. What was the budget deficit then and the trade deficit and the exchange rate regime?

Mr. BEST. What I think has happened is that in a way the discipline has been taken out of the system, and it is difficult, apparently almost impossible, to put it back in. The discipline at that time under a fixed rate system was that we had to protect reserves and try to keep things in some sort of an equilibrium. We would never have been able to allow deficits to grow to the proportions that they now are—domestic or international. The free float sort of gives us an internal liberty, but we are building up an overhang of problems that sooner or later will come home to roost. But it feels good when you can do whatever you want to and not appear to pay a price in the short run. It is sort of like the position of a Congressman or a Senator dealing with a $20 billion deficit versus a $200 billion deficit. If somebody offers a floor amendment that say costs $2 billion—for schools or harbors or roads or whatever—you might say, well, $2 billion is a lot of money, and, in a $20 billion deficit, that is 10 percent of the deficit. But if that same amendment were offered in a $200 billion deficit—if in other words it is a matter of whether it is $198 billion or $202 billion, you might say what the hell? It really doesn't matter, I might as well vote for the thing. [Laughter.]

I think that is where we are versus where we were a few short years ago.

Senator MOYNIHAN. If my friend would let me make a comment, I have to tell you, Mr. Best, that about a year ago I wrote an article for the New Republic in which I made a proposition that the great irony of this age is that Ronald Reagan has made big government cheap. It only costs you 75 cents on the dollar, so why not? And no cut would make it anywhere near balancing the budget, and no increase would make the deficit significantly larger.

The CHAIRMAN. Mr. Best also knows of what he speaks. He was serving as a staff member to this committee when $2 billion made a difference. Indeed, it was a discipline. Any other questions of these witnesses?

[No response.]

The CHAIRMAN. If not, gentlemen, thank you very much.

[Whereupon, at 12:35 p.m., the hearing was recessed, to reconvene at 2:30 p.m., this same day, April 23, 1985.]

AFTERNOON SESSION

The committee met, pursuant to notice, at 3:22 p.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Grassley, Matsunaga, Baucus, and Bradley.

The CHAIRMAN. I apologize. We have been listening to the President of the European Commission in the other room. And I'm going to leave him talking to some of the other Senators and proceed with the hearings here. I apologize for keeping you waiting.

Might we move to Mr. Robert Solomon from the Brookings Institution.

Mr. Solomon, again, I apologize for keeping you waiting. You go right ahead, sir.

STATEMENT OF MR. ROBERT SOLOMON, GUEST SCHOLAR, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. SOLOMON. Thank you, sir.

I'm pleased to have this opportunity to present my views to the committee. I have an abbreviated 5-minute statement.

In this statement I shall focus on what we know about the causes of the high value of the dollar, the effects of the strong dollar, and what might be done about it.

My remarks are aimed at helping the committee assess the relationship between international monetary arrangements and the working of the world trading system, including the advisability of a new round of GATT negotiations.

From the fourth quarter of 1980 until late February of this year, the trade weighted average value of the dollar against the currencies of 10 industrial countries rose about 80 percent. And then from late February until the last day or two, the average value of the dollar fell more than 10 percent, still up, then, something like 60 to 70 percent from late 1980.

What accounts for the substantial appreciation of the dollar since 1980? The most popular explanation links the dollar to high American interest rates, which in turn are thought to be the result of the sizable deficit in the budget. For much of the period since 1980, American short-term interest rates have exceeded those in Germany and Japan by 3 to 6 percentage points.

This means that an investor, by keeping funds in dollars rather than in marks or yen for a full-year, could earn an additional 3 to 6 percent, provided that the dollar did not fall in value during that year. The full-year gain of 3 to 6 percent could have been wiped out by a small depreciation of the dollar, and we know that exchange rates can move by 3 to 6 percent in a couple of days. I understand the Swiss franc fell by 5 percent today in the market.

Thus, investors who have put or kept their funds in dollars rather than marks or yens must have expected that the dollar would not fall, but would either remain stable or rise. The question is: Why did they expect the dollar to remain strong?

One reason may be that there has been an expectation that American interest rates would go up under the combined impact of the large budget deficit and economic expansion. Whatever the effect of the differential in interest rates between the United States and other industrial countries, there is little doubt that an increase in the interest rate differential is likely to push up the dollar when it occurs.

As long as investors hold the expectation of rising U.S. interest rates, they will tend to avoid nondollar currencies so as not to suffer a capital loss when American interest rates move up.

It was once widely thought that when a country developed a large trade and current account deficit its currency would depreciate. Clearly, that theory no longer holds or it's being overwhelmed by other forces.

One reason that is often given these days is that exchange rates are being driven by capital movements rather than by the fundamentals, such as trade deficits and surpluses.

It's important to note that this is not a new phenomenon. As far back as the early 1960's, the United States had a weak currency even though it enjoyed a sizable current account surplus. The problem was widely believed to be a tendency for capital to flow out of the United States in large volume. To deal with this problem, the United States used a variety of restraints on capital outflows to industrial countries during the 1960's and into the early 1970's. Thus, large capital movements with a tendency to effect exchange rates are not a recent development.

It has to be admitted that we cannot come up with strong and persuasive reasons for the rising value of the dollar in recent years. The interest rate differential, though it must have had an effect, depends on favorable expectations about the exchange rate, as I have said. The best analogy I can think of is the enormous increase in American stock prices in the second half of the 1920's. That was a speculative episode, as we all know. The market went up because people bought in the expectation that it would go up. And that, I think, is what has been happening to the dollar in recent years. It's a speculative bubble.

As we all know, the rising value of the dollar has had effects, both in the United States and abroad, and these are well known. Since they are well known, Mr. Chairman, I will skip over them in my oral summary. They are discussed in my written submission.

In general, there have been some benefits both in the United States and abroad from the appreciating dollar. But it is fair to say that welfare would have been greater on balance if the dollar had risen less.

I come to the question of, what can we do? If the world would be better off with a lower value of the dollar, what can be done about it? The standard prescription is to reduce the budget deficit. If Congress acted to cut the deficit progressively over a period of 2 to 3 years, this would lower both actual and expected interest rates. It could well lead to a decline in the foreign exchange value of the dollar. And since a smaller budget deficit is desirable on other grounds, there is everything to be said for acting on it.

A temporary import surcharge has been proposed, as you know. The proponents point to the precedent of the surcharge imposed by the Nixon administration in August 1971. It's useful to recall that the Nixon surcharge of 10 percent on American imports was a bargaining device designed to induce other industrial countries to agree to an appreciation of their currencies relative to the dollar. When such an appreciation was agreed to in December 1971, 4 months after the import surcharge was imposed, the surcharge was dropped.

Thus, the 1971 precedent has little relevance today.

In any event, the proponents of a surcharge see it not as a bargaining device, but as a means of reducing American imports and import competition. It is doubtful that this aim would be achieved. If nothing else happened except imposition of a surcharge, the dollar would probably appreciate and the effect of the surcharge would be nullified.

Those who look to the revenue effects of the proposed surcharge believe that a smaller budget deficit would lead to lower interest rates, and, therefore, a depreciation of the dollar. But it is unlikely, I believe, that financial markets would be impressed by a temporary increase in revenues from a temporary surcharge.

In conclusion, Mr. Chairman, the only practical move to deal with the strong dollar is to take action on the budget deficit, which is desirable in its own right. Does the fact that little else can be done in the way of policy steps to deal with exchange rates mean that our views about the world's trading system need to be revised? Not at all. Whatever the cost to the United States and to other countries of wide swings in the exchange rates, we would all be even worse off if barriers to international trade were put up. Such trade barriers would be very difficult to dismantle, whereas exchange rate movements do, in fact, reverse themselves.

What can be done in the longer run to reduce the variability of exchange rates? This committee will undoubtedly be presented, and presumably has already been presented, with proposals for target zones for exchange rates. These proposals require that monetary policy be directed at stabilizing currency values. The weakness in these proposals is that they fail to tell us how domestic economic growth and stability would be maintained if monetary policy were diverted to stabilizing exchange rates.

Until that question is answered, it is doubtful in my view that a system of target zones is feasible. One way to deal with this problem is to make fiscal policy more flexible so that it could deal with domestic economic stabilization while monetary policy aimed at exchange rates. But clearly that day is far off.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Solomon follows:]

PREPARED STATEMENT OF ROBERT SOLOMON, GUEST SCHOLAR, THE BROOKINGS INSTITUTION[1]

THE DOLLAR AND WORLD TRADE

In this statement, I shall focus on what we know about (1) the causes of the high value of the dollar, (2) the effects of the strong dollar, (3) and what might be done about it. My remarks are aimed at helping the Committee assess the relationship between international monetary arrangements and the working of the world trading system, including the advisability of a new round of GATT negotiations.

CAUSES OF STRONG DOLLAR

The dollar has risen in value almost steadily since 1980. From the fourth quarter of that year until late February 1985, the trade-weighted average value of the dollar against the currencies of ten industrial countries, as measured by the Federal Reserve Board, rose 82 percent. From late February to April 18, the average value of the dollar fell more than 10 percent. It is possible that the long upward movement of the dollar is finally being reversed, but that is something about which we cannot be sure.

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[1] The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution, its officers, trustees, or other staff members.

What accounts for the substantial appreciation of the dollar since 1980?

The most popular explanation links the dollar to high American interest rates, which in turn are thought to be the result of the sizable deficit in the budget. It is true that U.S. interest rates are, and have been, higher than in most other industrial countries. Yet the differential has not been large. For much of the period since 1980, American short-term interest rates have exceeded those in Germany and Japan by 3 to 6 percentage points. This means that an investor, by keeping funds in dollars rather than marks or yen for a full year, could earn an additional 3 to 6 percent, provided that the dollar did not fall in value. The full-year gain of 3 to 6 percent could have been wiped out by a small depreciation of the dollar. We know that exchange rates can move that much in a day or two.

Thus, investors who put, or kept, their funds in dollars rather than marks or yen must have expected that the dollar would not fall but would either remain stable or rise.

This leads us to the not-very-startling conclusion that the dollar rose because investors expected it to rise.

The question is, why did they expect the dollar to rise? One reason may be that there has been an expectation that American interest rates would go up under the combined impact of the large budget deficit and economic expansion. Whatever the effect of the differential in interest rates between the United States and other industrial countries, there is little doubt that an increase in that differential is likely to push up the dollar. As long as investors hold the expectation of rising U.S. interest rates, they will tend to avoid non-dollar currencies so as not to suffer a capital loss when interest rates move up.

Some observers claim that the dollar or the United States—or both provide a safe haven for investors abroad, who are said to have less confidence in the economic policies of their own countries than in those of the United States. This could well have been true in the case of some Latin American nations that have experienced severe debt problems. But when we talk about the strong dollar, we are viewing its value in terms of the currenices of other industrial countries, not developing countries.

Is there reason to think that investors have been moving funds out of Germany and Japan and into the United States because of a distrust of economic conditions and policies in those countries? This seems doubtful. If it were true, we would expect to see that residents of Germany and Japan were buying stock in Wall Street. This has not been happening. Moreover stock prices in those countries have risen more than those in the United States.

It was once widely thought that, when a country developed a large trade and current-account deficit—as the United States has—its currency would depreciate. That theory either no longer holds or is being overwhelmed by other forces.

One reason that is often given, these days, is that exchange rates are being driven by capital movements rather than by "the fundamentals" such as trade deficits and surpluses. It is important to note that this is not a new phenomenon. As far back as the early 1960s, the United States had a weak currency even though it enjoyed a sizable current-account surplus. From 1961 to 1967, the U.S. current-account surplus averaged $4.2 billion, whereas all OECD countries combined had an average surplus of only $2.7 billion. The problem was widely believed to be a tendency for capital to flow out of the United States in larger volume than could be financed by the current-account surplus. To deal with this problem, the United States used a variety of restraints on capital outflows to industrial countries.

Thus, large capital movements, with a tendency to affect exchange rates, are not a recent development.

It has to be admitted that we cannot come up with strong and persuasive reasons for the rising value of the dollar in recent years. We can reject the safe-haven argument. The interest-rate differential, though it must have had an effect, depends on favorable expectations about the exchange rate. The best analogy I can think of is the enormous increase in American stock prices in the second half of the 1920s. That was a speculative episode. The market went up because people bought in the expectation that it would go up. We call that a speculative bubble, of which there have been numerous examples in economic history.

EFFECTS OF STRONG DOLLAR

The rising value of the dollar has had impacts both in the United States and abroad.

In our country, the dollar appreciation has helped to bring down inflation, which has fallen from 12 percent in 1980 to 4 percent in 1984, as measured by the increase in consumer prices. It has also helped American tourists in Europe and Japan. But the appreciation has made life difficult for American exporters and producers who compete with imports. The import competition has led to demands for protection in the United States.

Since mid-1984, the slower growth of the U.S. economy is partly the result of the increase in the current-account deficit. While demand for goods and services by Americans has increased at an annual rate of 3.5 percent since the second quarter of 1984, GNP has gone up only 2.4 percent as a growing portion of that demand has been satisfied by imports.

In other countries, too, the effects of the rising dollar have been a mixture of the favorable and the unfavorable. On the plus side, the combination of the strong dollar and the vigorous recovery of the U.S. economy from the recession of 1981–82 has permitted many other countries, both industrial and developing, to enjoy export-led growth. As is commonly said, the United States has acted as a locomotive for the world economy.

On the minus side, other industrial countries have not welcomed the price effects of the depreciation of their currencies against the dollar. Such depreciation results in rising domestic-currency costs of imports that are priced in dollars. In order to dampen the depreciation of their currencies, a number of other industrial countries have maintained tighter monetary policies and higher interest rates than they wish to maintain, given their high unemployment and the sluggish growth of their economies.

Thus, although there have been some benefits, both in the United States and abroad, from the appreciating dollar, it is fair to say that welfare would have been greater, on balance, if the dollar had risen less.

WHAT CAN BE DONE?

If the world would be better off with the dollar at a lower value, what can be done to bring it about?

The standard prescription is to reduce the budget deficit. If Congress acted to cut the deficit progressively over a period of two or three years, this would lower both actual and expected interest rates. It could well lead to a decline in the foreign-exchange value of the dollar. And since a smaller budget deficit is desirable on other grounds, there is everything to be said for acting on it.

What else might by done? Intervention in foreign exchange markets by the United States has been held to a minimum in recent years. A case can be made that more active intervention by the American monetary authorities, in cooperation with those in other countries, might have prevented some of the upward movement of the dollar. But one cannot expect such intervention to drive the dollar down. That would violate the rules of the International Monetary Fund.

An import surcharge has been proposed as a way to deal with the effects of the strong dollar. The best-known proposal is for a three-year surcharge, starting at 20 percent and going to 7 percent in the third year before it is phased out. One of the arguments put forward by the proponents is that such a surcharge would bring in revenue and thereby help to reduce the budget deficit.

The proponents also point to the precedent of the surcharge imposed by the Nixon administration in August 1971. It is useful to recall that the Nixon surcharge of 10 percent on American imports was a bargaining device designed to induce other industrial countries to agree to an appreciation of their currencies relative to the dollar. When such an appreciation was agreed to in December 1971—four months later—the surcharge was dropped.

Thus, the 1971 precedent has little relevance today. Exchange rates are already floating. And the rise in the dollar is mainly the result of American policies. It might be argued that the surcharge should be used to wring trade concessions from other countries. This would probably backfire and lead instead to retaliation.

In any event, the proponents of a surcharge see it not as a bargaining device but as a means of reducing American imports or import competition. It is doubtful that this aim would be achieved. If nothing else happened except imposition of the surcharge, the dollar would probably appreciate and the effect of the surcharge would be nullified.

Those who look to the revenue effects of the proposed surcharge believe that a smaller budget deficit would lead to lower interest rates and therefore a depreciation of the dollar. But it is unlikely that financial markets would be impressed by a temporary increase in revenues from a temporary surcharge. Furthermore, it would be difficult to impose an across-the-board surcharge. Would it make sense to burden heavily-indebted countries like Brazil and Mexico with a barrier to their exports?

And if they were exempt, would it not be necessary to exempt all non-oil developing countries? They account for 30 percent of American imports.

CONCLUSIONS

The only practical move to deal with the strong dollar is to take action on the budget deficit, which is desirable in its own right.

Does the fact that little else can be done in the way of policy steps to deal with exchange rates mean that our views about the world's trading system need to be revised? Not at all. Whatever the costs to the United States and other countries of wide swings in exchange rates, we would all be even worse off if barriers to international trade were put up. Such trade barriers would be very difficult to dismantle, whereas exchange-rate movements do reverse themselves

What can be done in the longer run to reduce the variability of exchange rates? This Committee will undoubtedly be presented with proposals for target zones for exchange rates. These proposals require that monetary policy be directed at stabilizing currency values. The weakness in these proposals is that they fail to tell us how domestic economic growth and stability would be maintained if monetary policy were diverted to stabilizing exchange rates. Until that question is answered, it is doubtful that a system of target zones is feasible. One way to deal with this problem is to make fiscal policy more flexible, so that it could deal with domestic economic stabilization while monetary policy aims at exchange rates. Clearly, that day is far off.

The CHAIRMAN. One of the witnesses this morning gave us the opinion that if the dollar started to depreciate gradually we would see foreign countries starting to sell their dollar holding. But if it happened dramatically, a 20- or 30-percent drop quickly, they might hold onto them on the feeling that it has bottomed out, so why get out now? What do you think?

Mr. SOLOMON. When you say "foreign countries," I assume you mean investors abroad rather than governments——

The CHAIRMAN. Yes. Private investors abroad.

Mr. SOLOMON. I think there is probably something to that point.

The CHAIRMAN. If they saw it coming gradually, they might get out. But if it happened quickly——

Mr. SOLOMON. If they started to get out, Senator, then it wouldn't remain gradual.

The CHAIRMAN. No, that's true. And those that didn't get out would then stay in?

Mr. SOLOMON. Well, I think the upshot of what you are saying is that it is unlikely to be gradual; it all depends upon expectations. If people have the feeling that, at any moment, 10 percent is all it's going to be, then when you've gotten that 10 percent, they are satisfied, as may have happened today. If somehow the general expectation is 20 percent, then it will probably go 20 percent. That doesn't tell us very much unfortunately, but it's hard to go beyond that.

The CHAIRMAN. That's the converse of what you said. When the dollar is going up, people buy it on the assumption it's going up. And when it finally reaches as far as it is going to go, if you know that, that's when you quit buying.

Mr. SOLOMON. And, in fact, there isn't a single expectation in the market but a whole spectrum of views in the market.

The CHAIRMAN. But the bottom line is your advice right now is the best we can do is to narrow the deficit right now.

Mr. SOLOMON. I think that would be the No. 1 priority. I've got something in my statement about intervention in foreign exchange markets which has a moderate effect, and I certainly would not eschew that path.

The CHAIRMAN. Oh, no, just in terms of priorities.

Mr. SOLOMON. Right. Absolutely.

The CHAIRMAN. Senator Bradley, go ahead.

Senator BRADLEY. Thank you, Mr. Chairman.

So you believe that we could get some downward pressure on the value of the dollar if there was a kind of selective intervention. Is that correct?

Mr. SOLOMON. Well, not so much downward pressure, Senator. I think the role of intervention would be to dampen upward movement of the dollar when it is appreciating. If it's already falling, I don't think we are——

Senator BRADLEY. Let's take a point in time since, as you know, it goes up and down.

Mr. SOLOMON. OK.

Senator BRADLEY. Let's say that our objective is to get the dollar down, say, 20 to 30 percent. What role do you think intervention can play in beginning that process or accelerating that process?

Mr. SOLOMON. I think the Federal Reserve and the Treasury, in cooperation with central banks abroad, could sell the dollar when it starts up. Buy foreign currencies on those days when the dollar is going up. That would tend to cut off the upward movements, and then you would let the downward movements take their own course, and you would, as a result, get a net downward path.

Senator BRADLEY. I understand. I'm trying to get your estimate as to how much you think that we could affect things if we did intervene. In other words, you can hold off the move upward—you can intervene and hold off the move upward for a certain period of time. And if the move goes downward, you can accelerate it by intervention.

Now if the move starts downward, how much can you accelerate it further than it otherwise would go?

Mr. SOLOMON. I don't think anybody can answer that question, Senator Bradley.

Senator BRADLEY. Is it the black hole?

Mr. SOLOMON. You mean a bottomless pit?

Senator BRADLEY. Yes. I've heard arguments against doing anything as long as that's the black hole.

Mr. SOLOMON. And we would spend billions of dollars. Incidentally, it's often said by critics of intervention that we would be using the taxpayers' money. That is simply incorrect. The Fed would be exchanging one asset for another if it were intervening. And that is not using taxpayers' money. If they made losses, there would be less revenue to the Treasury, that's true.

I don't know whether it's a bottomless hole. We don't know. I think it would be useful to try it and see what happens. We haven't really tried it in a serious way in recent years.

Senator BRADLEY. What role do you see in our present economic circumstance—what role do you see the Third World debt playing? In other words, if we managed to restructure the Third World debt, would that help or hurt? lower interest rates, longer terms?

Mr. SOLOMON. Well, if you lower the interest rates on the debt of Third World countries, if that could be managed, it would mean that they could use more of their export revenues to purchase our goods and goods of other industrial countries. In that sense, it would help us. It would also help them. They would have higher real incomes rather than using what they do earn to pay interest.

But how you get the lower interest rates on that debt is another question.

Senator Bradley. One of our witnesses this morning suggested that the United States establish a strategic currency reserve. Is that something that you could be supportive of?

Mr. Solomon. Well, I think that's just the other side of the coin of intervening today. If we intervene today, we would be acquiring Deutsche marks and yen and other currencies and that would go into the holdings of the Fed. And if you want to call that a strategic currency reserve, there is no reason not to do so.

Senator Bradley. Is that a good thing to do?

Mr. Solomon. Well, since we've already agreed, you and I, that it would be a good thing to have some intervention, we have agreed that it would be a good thing to acquire some currencies.

Senator Bradley. How big should the reserve be? Fifty billion?

Mr. Solomon. I don't know. My emphasis would be on the desirability of the intervention rather than the buildup of the reserves, as you and I discussed it a moment ago.

Senator Bradley. All right. Thank you.

Mr. Solomon. Right.

The Chairman. Mr. Solomon, thank you very much. And, again, I apologize for the delay.

Mr. Solomon. Thank you, Senator.

The Chairman. Now if we could have Mr. Danielian and Mr. Srole.

Mr. Danielian, go right ahead.

STATEMENT OF MR. RONALD L. DANIELIAN, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION, WASHINGTON, DC

Mr. Danielian. Thank you, Mr. Chairman. I have an oral summary that I would like to go through.

The Chairman. Your entire statement will be in the record.

Mr. Danielian. Mr. Chairman, I think this Nation is in trouble. We are running serious balance of payments deficits, building debts abroad which are future claims on U.S. resources. We continue to rely on failed policies and floating exchange rates to make corrections.

In May of 1971 my association testified before your committee and stated:

> There is now a fad of urging flexible exchange rates or reevaluation of other currencies; that is to say, a defacto devaluation of the dollar as a solution to the American balance of payments deficits. The belief that flexible exchanges or reevaluation of other currencies will turn the trick on our commercial transactions is a hangover from classical international trade theory. Unfortunately, this is not applicable to a world where the classical model of competition, free trade and mobility of capital and labor simply does not apply.

In 14 painful years, Mr. Chairman, we haven't learned our lesson. Currency swings are responsible for up to $50 billion of our trade deficit. In addition, the U.S. budget deficit is a serious drain on our resources. It encourages current consumption through the borrowing of foreign funds, building up liabilities abroad and bringing higher interest rates that affect the dollar's value.

It is extremely important to reduce this deficit as one part of the program, but that would not be a cure-all. Our trade and balance of payments deficits transcend this era of very high budget deficits and we are still facing nontariff barriers abroad which we must eliminate if we are to preserve an open trading environment. Yet these problems have been building for years. We have had sizable trade deficits since 1971 and a current account deficit on actual transactions since 1968.

The most striking fact, often lost in the clamor of today, is that in the last decade, despite continual drives to open up foreign markets, only in 1975 with the recession, did the United States have a surplus on its current account.

As Benjamin Franklin said, "Few things are harder put up with than the annoyance of a good example." And we should learn by the example of the United Kingdom where growing debt and balance of payments crises forced them into stop-go domestic economic policies in the late 1960's and early 1970's. Most important, however, was the strategic implication of the British problems. The severity of their payments crisis reached a peak toward the end of the 1960's when the pound became one of the sick men of Europe. But Britain's problems finally came to a head and led to a reassessment of its ability to continue financing overseas activities with foreign exchange that it did not have.

One casualty was overseas defense expenditures which could no longer be sustained at previous levels. Britain pulled back from its east-of-Suez military obligation, especially the Middle East and the Indian Ocean in part to save foreign exchange costs.

We could potentially find ourselves in the same situation where we would be forced to restrict internal domestic demand to save domestic production for export rather than internal consumption. Down this route lies a significant change in our terms of trade and a reduction in U.S. living standard. Ultimately, we could face a foreign exchange crisis.

Because the U.S. dollar has not responded according to classical theory, world trade is no longer being conducted on the basis of comparative advantage, causing a distinct inefficiency in the flow of resources on a global basis. The real question in forming a solution is, how do you make the system adjust for different national policy complexions without resorting to pure protectionism?

We need an honest perception of our position and a new direction in international economic policy. We have suffered from a delayed perception of basic changes in world economic forces. No longer the largest single economic group in the world, we cannot act as if the rest of the world will automatically follow us. Our past negotiating style has been to open up our markets without really making sure that other markets have been truly open to us. We have had political objectives in negotiating agreements and sometimes those objectives have overshadowed the economics.

With certain countries, we have had a continuing problem that we have failed to address. This is the case with Japan, which represents a different and unique situation that cannot be hidden by the fact that in 1985 we have substantial deficits with other trading partners.

Our trade and current account deficits with Japan have been in deficit every year since 1965—the problem is not of a current nature. The United States must continue to push for open markets and our policies must change to reflect the problems we now face.

As Abraham Lincoln said, "As our case is new, so we must think anew and act anew."

To find our way back to a policy of expanding rather than restricting the opportunities for trade, we must regain control of access to U.S. markets so negotiations can be successful in obtaining respect for the principles of most favored-nation, national, and reciprocal treatment. Access to our markets must be conditional on adherence in practice to these principles.

The **CHAIRMAN**. What did you say? Must be what?

Mr. **DANIELIAN**. Access to our markets, Senator, must be conditional on adherence to these principles by other countries. And the application of the principles should not be confined merely to trade movements. It must encompass investments, repatriation of earnings, industrial property rights, and any other considerations of quantitative economic value. Economic progress, Mr. Chairman, is indivisible: Trade, investment, services, property rights, travel, and other parts of the balance of payments are all interdependent and a misalignment in one leads to problems in the others.

While we should never openly protect inefficient industries through trade barriers, where we currently have a comparative advantage, we should not allow the action of others to force us into noncompetitive positions.

I have outlined in my full statement what I believe are some of the steps necessary to make adjustments for a new direction toward an open, efficient trading system and these include:

Using conditional, most-favored-nation trade status for future access to our markets;

Resolving not to use voluntary quotas for controlling imports in crisis situations but rather to rely on increased tariff rates by agreement as a preferred method;

Insisting that performance requirements be avoided on our foreign investments. The degree of access to the U.S. market should also consider such requirements as they should be part of a negotiating process;

Avoiding changes in our tax system which disadvantages foreign exchange earnings or reduce investment needed for future growth;

Considering the use of exchange adjusted tariffs since floating exchange rates do not equilibrate the traded goods sector. These would adjust the trade effect of misaligned currencies and return us to a system of open markets that compete on the basis of comparative advantage in real costs.

This committee may wish to refer the last consideration to the International Trade Commission for an objective analysis. While I outline one variant in my statement, other variants of this concept should be explored.

Mr. Chairman, I have appreciated the chance to give the committee my views. Some of my suggestions may seem unorthodox, but they highlight my view that our solutions to maintaining an open trading environment involve several interrelated actions. All of them together can have an effect. However, we cannot wait for reductions in our budget deficit, as important as that is, to lower our interest rates and dollar exchange rates. When the rates are lowered, we will still face serious payments problems. We must, in fact, be more aggressive in maintaining open markets.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Danielian follows:]

STATEMENT OF RONALD L. DANIELIAN
PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

April 23, 1985

Mr. Chairman:

Thank you for inviting us to testify at your hearings on the viability of the international trading system in an era of floating exchange rates. My name is Ronald L. Danielian and I am president of the International Economic Policy Association--established in 1957 as the first nonprofit organization to analyze public policy issues in the international economic arena. These have included international trade, investment, taxation, raw materials and exchange rate policy questions as well as international monetary issues. We have published several books on the U.S. balance of payments and one on U.S. Foreign Economic Strategy for the Eighties.

Mr. Chairman, this nation is in trouble. We are running serious balance of payments and trade deficits, building debts abroad which are future claims on U.S. resources. We continue to rely on failed policies and floating exchange rates to make corrections. In May of 1971, my Association testified before this Committee that the use of flexible exchange rates as a solution to the American balance of payments deficits was a hangover from classical international trade theory and that it was not applicable to a world where the classical model of competition, free trade, and mobility of capital and labor simply does not apply. In fourteen painful years, we haven't yet learned our lesson.

What is new today is the severity of our situation. Imports account for 10 percent of our GNP, while over a decade ago they were about 2 percent. They accounted for 15 percent of our domestic demand for goods in 1984, a full one-third greater than five years before. Imports (aided by misaligned currencies) have a depressing effect on certain sectors of our domestic economy, creating economic imbalances. For instance, the industrial production index has been flat for almost nine months and employment in the manufacturing industries has not grown recently. We believe that the stagnation in employment and the dislocations in manufacturing, agriculture, and mining are closely related to our trade deficits, fed by foreign barriers and currency shifts.

Import penetration is so severe that:

- The capital goods industries have lost 387,000 jobs since 1980 and combined with auto and other transport employment, the job loss amounts to 500,000.
- Last year one-half of every dollar spent on capital equipment went for overseas purchases.
- 40 to 50 percent of domestic machine tool sales in the United States has come from abroad.

We believe that currency swings are responsible for up to $50 billion of our trade deficit. In addition, the U.S. budget deficit is a serious drain on our resources. It encourages current consumption through the borrowing of foreign funds, building up liabilities abroad and bringing higher interest rates that affect the dollar's value. It is extremely important to reduce this deficit as one part of the program, but that would not be a cure-all. Our trade and balance of payments deficits transcend this current era of very high budget deficits. And we are still facing nontariff barriers abroad which we must eliminate if we are to preserve an open trading environment.

> "The nearer any disease approaches to a crisis,
> the nearer it is to cure."
> -- T. Paine

The United States faces a crisis in its ability to earn foreign exchange and pay its way in the world today without borrowing from foreigners and mortgaging the future. Yet these problems have been building for years and transcend the era of bloated budget deficits. Except for the recession year of 1975, we have suffered sizable trade deficits since 1971, and those deficits have mushroomed in the 1980s to $123 billion ($108 billion on a balance of payments basis).

Our investment and services account can no longer overcome our deficit in trade. Thus, the United States current account measuring all current international transactions was in deficit by $102 billion in 1984.[1] This, too, is not a recent phenomenon. In fact, the United States current account on actual transactions (excluding the overstatement of net reinvested earnings) has been in deficit since 1968 (excluding the recession year of 1975). In the past, however, our current account deficits on actual transactions were manageable, ranging between $1 billion and $9 billion. They could be financed by reasonable inflows of capital from overseas and in aggregate terms up until about the mid-1970s, the cumulative balance was positive.

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[1] $110 billion on actual transactions.

For the current account, we were able to cover our imports of goods and the cost of military expenditures abroad through the sale of U.S. services, the return on U.S. foreign assets in the form of repatriated income from U.S. direct investors overseas and small manageable inflows of foreign capital. Starting in 1977, however, the hemorrhage both in our trade and our current account was too severe for our export earnings or return on investments and services sales abroad to balance out--even over time. We therefore stand today as one of the world's largest debtor nations--exceeding in one year the total debt of Mexico. Our ability to spend abroad relies on the inflow of foreign funds, attracted by today's extremely high real interest rates. Thus, to finance military and aid expenditures abroad, and to allow foreign goods unrestricted access to the U.S. market without the quid pro quo of open access for our goods, we must borrow money.

It must be noted that excess U.S. dollar liabilities abroad persisted in earlier years under the former measures of our balance of payments. These measures included the liquidity balance, the official settlements balance, and the basic balance used at various times up to 1972. No matter how the definitions were changed, we still had a deficit and built up dollar liabilities abroad.[1]

> "Change is the password of growing states."
>
> -- G. E. Woodberry

The nature of the U.S. trading relationships has changed over the years, and our flow of trade has risen faster with new areas such as Asia than with previous markets such as Europe. And our overall trade accounts have shifted from near balance or positive to deficits with all major areas. Table I shows our deficits with various regions. In major product categories, except for agriculture, the United States is suffering from ever-increasing trade deficits or a substantially reduced surplus. And even in agriculture our surplus has slipped as U.S. policy mistakes such as export embargoes have allowed competitors to garner a significant share of what used to be our primary foreign markets. Table II-(a-e) shows the balance in major product categories since 1957. The same pattern is repeating on the services account, where our surplus is being reduced. Table III shows the real current account position and overall trade position from 1960-1984. In the last decade, despite continual drives to open up foreign markets, only in the depths of the recession in 1975 did the United States have a surplus on the current account.

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[1] The United States Balance of Payments: From Crisis to Controversy, (1972); The United States Balance of Payments: A Reappraisal (1968); The United States Balance of Payments: An Appraisal of the U.S. Economic Strategy (1966), International Economic Policy Association, Washington, D.C.

The origins of this deficit go beyond our extremely high budget deficits of today. If you lower our budget deficit, it will have a positive effect on the current account but it will not solve our problem.

> "A little neglect may breed great mischief."
>
> -- B. Franklin

The international report of the President's Council of Economic Advisers does not view the current account deficit with alarm. Unfortunately, its members accord the balance of payments the same benign neglect that past administrations have given to floating exchange rates. The report states that the "deficit is not necessarily a negative factor for the economy as a whole. A current account deficit merely implies that . . . U.S. residents are purchasing more goods and services than they are now producing. Its counterpart is a capital account surplus which measures the net claims on U.S. residents that foreign residents have accepted in payment. Thus, net capital inflow provides the financing for an excess of current expenditure over output."

This statement is an assets and liabilities account of our international transactions. Just as with any corporation, assets and liabilities must balance out. But one can pick American companies that are in difficult times, earning no profits (possibly paying dividends with borrowed funds), whose assets and liabilities balance.

The key flaw in the statement is the implied assumption that "net claims" can safely keep on rising.

As a nation, we have switched in the last decade from the healthy side of the assets and liabilities statement to the unhealthy side where we sustain our growth on borrowed funds, building up foreign claims against the United States. This is no different from the obligations deriving from our domestic budget deficit that future generations must ultimately pay. The United States must be prepared in the future to pay off its international claims. As interest charges mount and we try to live on borrowed money rather than building future earning assets, there will be less and less for growth. When the burden reaches its peak and the dollar depreciates, inflation will follow. We will face October 1979 all over again, when interest rates rose as the Fed increased the discount rate twice in one month and credit controls were applied.

In classicial economic terms, economies paid off international debts by reducing domestic consumption to save productive capacity for export earnings--foreign exchange. Countries in balance of payments deficit needed to reduce domestic economic activity relative to the rest of the world. Major domestic adjustments similar to the IMF prescriptions for the debt-ridden LDCs are most appropriate.

> "Few things are harder to put up with
> than the annoyance of a good example."
>
> -- B. Franklin

Growing debt and balance of payments crises forced the British into their stop-go economic policies of the late sixties and early seventies. Most important, however, were the strategic implications of the British problems. The growth of foreign income from earning assets abroad filled in for the lack of foreign exchange created by constant trade and services deficits in the 19th and first part of the 20th century, and supplied most of the surpluses for Britain's foreign activities.[1] But the forced sale of overseas private investments to meet war obligations cut earnings. This plus a substantial rise in military expenditures[2] ultimately led to chronic debt and overall balance of payments problems after World War II.

The severity of the British payments crisis reached a peak toward the end of the 1960s when the pound became one of the "sick men" of Europe. In 1967, sterling was devalued by 14.3 percent, yet the crisis persisted. Later, world bankers met in Basel to agree on a "sterling guarantee" package. The massive sterling problems and the stop-go economic policies tried as a cure finally led to a reassessment of England's ability to continue financing overseas activites. One casualty was overseas defense expenditures, which could no longer be sustained at previous levels. Britain pulled back from its "East of Suez" military obligations (especially the Middle East and Indian Ocean) in part to save the foreign exchange costs which were no longer sustainable and in part to satisfy the political orientation of the labor government.

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[1] See: Economic Elements of the Pax Britannica, Albert Imlah, Harvard University Press, Cambridge, 1958.

[2] Britain's Economic Prospects, The Brookings Institution, Richard Caves and Associates, 1968.

The United States could conceivably find itself in the situation where we must restrict internal domestic demand to save domestic production for export rather than internal consumption. Down this route lies a significant change in our terms of trade and a reduction in U.S. living standards. The United States cannot live on borrowed funds indefinitely. We can do so in the short term at the cost of higher interest rates (to attract foreign funds) and loss of jobs and investment as the dollar stays overvalued and other currencies are undervalued. In addition, our ability to function internationally hinges on the dollar's acceptance as a universal medium of exchange. But the time may come when the dollar is used less and less and the currency of other groups of nations takes over as an international reserve. The pattern is not unlike what happened to the pound sterling when its role as a major reserve currency waned in the latter part of the 1960s. Then Americans will not be able to enjoy unrestricted travel or to import what we want, and we will be restricted in our foreign operations.

> "The Almighty Dollar, that great object of
> universal devotion throughout our land."
>
> -- Washington Irving

U.S. productive efficiency has actually increased over the past few years while the U.S. current account balance has been falling sharply. U.S. overall productivity has advanced at a faster annual rate than in the past--at 3 percent--and U.S. industry has become extremely efficient. In manufacturing alone, however, U.S. productivity rates have increased but lagged behind our trading partners (see Table IV). Yet we need to attract $110 billion to cover a current account deficit and continue our domestic economic expansion. Accomplishing this through higher interest rates has swelled the value of the dollar to such an extent that productivity increases alone are not able to overcome its 30-40 percent over-valuation or any under-valuation of other currencies.

Under normal circumstances, the U.S. exchange rate should be depreciating so that we could overcome our payments imbalance. Because it is not, world trade is no longer being conducted on the basis of comparative advantage, causing a distinct inefficiency in the flow of resources on a global basis. As an example, the United States has always been the most efficient agricultural nation. At one time our agricultural products could be produced and sold for less than half the cost of comparable products in other countries. That is no longer the case. We have reached the point where U.S. agricultural companies such as Cargill have even considered importing grains into the United States because in dollar terms it would be cheaper than buying in the U.S. farm belt! In the past, the European Common Agricultural Policy subsidized the exports of member countries up to 50 percent of the cost of production. But because of the strength of the dollar in foreign exchange terms, U.S. agricultural products are so expensive now that there is almost no subsidy element in European exports to third country markets. This is true despite the fact that in local terms it can cost twice as much to produce agricultural products in Europe as it does in the United States.

In the export of goods, the United States supplied over four-fifths of the commercial aircraft in the world, but we no longer hold that position because of severe competition from European and other manufacturing bases. A major factor in the continuing loss of market share in this product has been the substantial overvaluation of the dollar. Pan American World Airways, for instance, has broken a long association with the Boeing Aircraft company to buy up to 28 European manufactured airbuses worth approximately $1 billion. This is despite the fact that its present system is geared, from mechanics to spare parts, to the Boeing aircraft. In foreign exchange terms, the 30 percent overvaluation of the dollar had a significant impact on bringing down the dollar cost of that equipment purchase. Since the export credit agencies in Europe assume the risk for exchange rate fluctuations without charging a premium for airbus sales financed in dollars, a potential $300-$400 million savings can be passed on to the buyer. This is a tremendous price advantage for an American airframe manufacturer to overcome.

> "A condition confronts us--not a theory."
>
> -- Grover Cleveland

The use of classical theory to frame a policy of floating exchange rates that self-equilibrate international payments has been misplaced. It was first expected that floating exchange rates would free national economic policies from exchange rate concerns. By automatically adjusting, it was felt, the market would remove the need for governments to defend a fixed rate and give nations greater freedom to adopt macroeconomic policies in pursuit of purely domestic targets for employment and growth. The exact opposite has occurred.

Fourteen painful years of strains in the international economy, loss of market shares for the United States, and reduced potential GNP growth have shown that we were right when we stated in 1971 that "There is now a fad of urging flexible exchange rates or revaluation of other currencies, that is to say, a de facto devaluation of the dollar as a solution to American balance of payments deficits. The belief that flexible exchange rates or revaluation of other currencies will turn the trick on our commercial transactions is a hangover from classical international trade theory. Unfortunately, this is not applicable to a world where the classical model of competition, free trade, and mobility of capital and labor, simply does not apply."[1]

For floating rates to work as envisioned, major nations would have to get together and adjust relative fiscal and monetary policies for an appropriate mix. Some nations would have to be willing to give up employment or growth and others would have to allow more inflation. It is extremely difficult to imagine countries of vastly different political, social or economic persuasion voluntarily agreeing to such targets on a yearly basis. The real question is, how do you make the system adjust for different national policy complexions without resorting to pure protectionism?

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[1] May 1971 IEPA statement before the Senate Finance Committee.

Protectionism is inefficient and raises costs to all concerned, yet the greatest breeder of protectionism on a global basis is a grossly under- or over-valued currency. It provides a tax or subsidy, whichever the case may be, and instills inefficiencies in the global movement of goods, services, and investments. New policies are needed to extricate ourselves from this problem; a new direction is appropriate.

The United States has suffered from a delayed perception of basic changes in world economic forces. We are no longer the largest economic grouping in the world, and we cannot act as if the rest of the world will automatically follow us. When the General Agreement on Tariffs and Trade was negotiated in 1948, it was biased in favor of countries needing our help; for instance, it included a grandfather clause continuing the British Commonwealth preference system, and it authorized common markets and free trade areas in the interest of Western European unity, even though these are clear denials of the unconditional, most-favored-nation principle inherent in the document. During successive rounds of negotiations going back to the 1950s, we adhered to the principle of MFN. We thus allowed third parties, who were emerging industrial powers, to obtain favorable tariff rates on imports into the

United States without necessarily giving us a reciprocal bargain. Our objectives then leaned toward shaping a healthier "economic" world and helping others because we could afford to at minimal U.S. cost.

When world levels on automobile tariffs were negotiated under the Kennedy Round in 1968, the United States ultimately agreed to a low duty rate of about two percent. The Japanese were able to receive the same low dutiable rate under MFN while their rates on autombile imports remained high, and while they denied or restricted the ability of U.S. automobile firms to invest in Japan. Of course, Japan was not then a significant manufacturer of autos--Europe was the second largest producer, and there was a complementary relationship between trade and investment as both were freely allowed across the Atlantic. Yet, as markets changed, the static agreement made under past conditions did not, and there was no opportunity for a complementary trade and investment relationship across the Pacific. This relationship is a key to our trade and payments imbalance with Japan today.

In 1960, we agreed to a separate interpretation of Article XVI of GATT defining our direct income taxes as not rebatable, and making European cascade or value-added taxes rebatable on exports and chargeable against imports. This was at the suggestion of the French and was thought to encourage cohesion within the Common Market so that our dream of a political as well as economic union would be fulfilled. The world has changed from our past perceptions, but our policies have not.

In 1968 we allowed negotiations under the Kennedy Round to be completed in the nonagricultural sector alone--a sector in which the United States had been in a trade deficit. But we set aside discussions on agriculture, then our primary breadwinner. In the later 1970s, we agreed to lower our dutiable rates on telecommunications equipment from Canada to a two percent level, while the Canadians retained a 17 percent duty for our shipments to them. And in 1979, under the Trade Agreements Act of 1979, the U.S. Congress sanctioned for the first time in law the 1960 interpretation that U.S. direct income taxes are not rebatable on exports. The world had changed considerably but our negotiators stuck to old beliefs. Nevertheless, the United States continued to protest that such tax rebates lead to a less than equal opportunity to compete, especially in third country markets. Our DISC, now the FSC, was an effort to equalize the playing field.

Even today, we are willing to give unilateral economic benefits to others for undefined political reasons. The U.S. Administration has asked the Congress to grant the harder standard of an injury test on unfair or countervailing trade practices with Mexico. This despite the fact that Mexican performance requirements on investment are tantamount to a kidnapped plant policy--come down and invest or lose your present stake, and when you invest you must export. Also, I understand that the Congress has not been told exactly what we are prepared to give up and the justification therefor, in exchange for achieving an opening for services trade in new MTN negotiations. I would hope we don't rush in and give up another sector such as agriculture.

> "Let us have the courage to stop borrowing to meet continuing deficits."
>
> -- Franklin Delano Roosevelt

The United States does not have an economic surplus in foreign exchange terms with which to grant unilateral concessions to foreign nations. We cannot afford to give up access to our markets for some undefined objective without making sure that such access is fully reciprocal. The expenditure of foreign exchange for activities that do not bring an economic return can lead to an increase in our international payments deficit. For instance, there are times when we should not be giving aid in money terms. Rather, the United States should supply to the world real (hard goods) resources, of which we have an abundance, considering our present excess capacity. We can afford to give tractors and pay for U.S. engineers or other U.S. services to be performed abroad as a gesture of our compassion and aid. Or we can afford to give surplus food to those in need. We cannot afford to give dollars freely, since we are one of the world's largest debtor nations. To give we must borrow.

Of course, this is parallel to our domestic budget deficit-- to spend on government programs we must borrow.

"There is nothing so powerful as truth;
and often nothing as strange."

-- Daniel Webster

It is not sufficiently realized that in foreign exchange terms on an overall basis the United States has had a balance of payments deficit since 1950, except in 1957 after the Suez crisis. We built up liquid liabilities abroad (the old liquidity payments balance) as government expenditures for aid and defense outstripped our commercial surpluses. Later, on an official settlements basis, we continued to build up dollar liabilities abroad. On a basic balance basis (the current account plus long-term transactions),[1] we also ran a deficit. Today, on a current account basis, we still have significant deficits.

On a commercial basis, we have had persistent trade deficits since 1971 (in 1977 they reached crisis proportions) and current account deficits since 1968 (see Table III). The fact that we have been running deficits means that we are transferring purchasing power to foreigners, in essence, giving future claims to U.S. resources. In the 1980s, our deficits on both accounts have mushroomed to crisis proportions and year after year we are building up more liabilities abroad. In a detailed look at our trade and official current account balances with various regions, the truth is indeed strange.

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[1] For a description of these past measurements and a historical perspective of the facts, see: The United States Balance of Payments: An Appraisal of U.S. Economic Strategy (1966), IEPA, p. 159.

Table V shows our balances with major trading partners. Excluded from these tables is Japan which I shall treat separately. As can be seen, our accounts with these areas have varied between surplus and deficit, until 1983 when we began to run trade and/or current account deficits with all of our major trading areas. Moreover, while our problem in general is serious and our accounts have deteriorated, our situation is even more critical with Japan. The recent talk that "Japan isn't the only problem," is true but it is a smokescreen that clouds the problem.

With Canada, for instance, the United States had a $10 billion trade deficit in 1983, but we still had a small current account surplus. For Germany alone the special problem of our NATO expenditures there accounts, at times, for 75 percent of our current account deficit. This is an issue that must be considered separately.

Because of the tremendous rise in the value of the dollar and the decline of other currencies, the final figures for 1984 show a further massive deterioration in our accounts. Historically, in those times when the dollar was depreciating substantially, by up to 30 percent, such as between 1978 and 1980, our trade accounts and/or current accounts responded accordingly--we were able to sell more and improve our foreign exchange earnings.[1] This, however, has not been true with regard to Japan. Japan represents a different and unique case which cannot be hidden by the fact that today in 1985 we have substantial deficits with our other trading partners.

Table VI shows our trade and current account deficits with Japan since 1960. As can be clearly seen, our Japanese problem is not of current origin. We have had a growing trade and current account deficit with Japan in every year since 1965. As we enter our third decade of problems with this country, it is difficult to fall back on the excuse that U.S. trade problems go beyond Japan . . . or that all we need is more time. The anomaly with Japan is that past U.S. trade and current accounts have not responded to what theory and common sense tell us should happen when one economy grows faster than another and when one currency depreciates in value against another.

Many have argued that our trade deficit will eventually improve as rates of economic expansion in the United States and Japan come closer. If the dollar depreciates, our trade should also improve with Japan. The contrary, however, is closer to the truth. The facts of U.S.-Japanese trade simply do not support the normal economic principal that aggregate internal demand or a depreciation of the dollar will be a prime mover in increasing trade and correcting our deficit with that country.

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[1] A depreciation can help but is muted by the "J" curve lag in trade effects, and because some countries peg their currencies to float with or below the dollar. About 65 percent of our trade is with such currencies; thus, less benefit would accrue to the U.S. from these nations.

For instance, in every year since 1973, the growth in Japanese gross domestic product (a good indicator of internal aggregate demand) has exceeded that of the United States. In the years 1978 through 1980, the dollar was depreciating by 30 percent, which should have given us an additional trade advantage, and Japanese growth significantly outperformed that of the United States. Thus, we should have encountered substantial increased trade opportunities, leading to a significant correction in our trade balance with Japan. Instead, our deficit with Japan hovered between $8.6 billion and $11.6 billion. In 1979, real growth in Japanese GDP was 5.1 percent versus 2.3 percent in the United States, and in 1980 it was 4.9 percent versus -0.2 percent in the U.S., yet our trade deficit increased from $8.6 to $10.4 billion. In 1981, Japan grew one full percentage point faster than the United States, while our trade deficit increased from $10.4 to $15.8 billion. And in 1982, although Japan grew a positive 3.2 percent and we were in the throes of a recession (a 2.4 percent decline), our trade deficit increased by another $1 billion! This performance probably reflects the unrealistic strengthening of the U.S. dollar and the corresponding weakness of the Japanese yen; but throughout the last decade, more than currency swings or domestic growth would have been necessary to remedy the "Japan problem."

I maintain that U.S. policies must change to reflect these facts.

"As our case is new, so we must think anew and act anew."

-- A. Lincoln

We can find our way back to a policy of expanding rather than restricting the opportunities for trade by regaining control of access to the U.S. market so that in negotiations we can reestablish respect for the principles of MFN, national and reciprocal treatment. Access to our markets must be conditional on adherence to these principles by other countries, and the principles should not be applied merely to trade movements. They must encompass investments, repatriation of earnings, industrial property rights, and any other considerations of economic value. Economic progress is indivisible; trade, investment, property rights, travel, and other components of the balance of payments are all interdependent and a misalignment in one leads to problems in others.

We must realize that today's world is not that of the fifties and sixties. As just one of the major international economic players, the United States should cease to act as if its size and status demand a higher standard of self-sacrifice than any other major country accepts. Whatever validity to this notion might remain, the special conditions that prevailed after World War II and Korea have been corrected in part by America's generosity. Having met the special obligations imposed by our relative affluence at that time, the United States should begin to act as coequal with other countries now that we have major domestic priorities and problems of our own. And while we must continue to carry out our basic responsibilities, we also must insist on a more open and reciprocal treatment in our future economic relationships.

We should never openly protect inefficient industries through trade barriers, but we should not allow the actions of others to force us into noncompetitive positions.

In order to make the necessary adjustments towards an open, efficient trading system, we should follow the principles laid down under Section A below. These principles have been long supported by IEPA and for the most part are not significant departures from accepted rules or practices today. Under Section B, we propose some principles that should be considered if imbalances and severe dislocations persist. These proposals may be legal remedies accepted by the trading community, or some may be more controversial, but they are advanced in an effort to forestall purely protectionist reactions.

A. Principles to Follow

A-1. The United States must adopt a conditional most-favored-nation trade status that rests on reciprocity and national treatment in both trade and investments. Insisting upon true respect for the principles of national, reciprocal, and MFN treatment, we should condition future access to our markets on adherence in practice to these principles by our trading partners. Third countries which do not agree to the stipulations between two trading partners should not benefit to the same degree from the lowering of barriers between the two primary parties. The effort here is to structure our negotiations along the lines of the Tokyo Round MTN government procurement code, subsidies code and other agreements. Only the countries that agree to codes get the benefits of those codes.

A-2. Voluntary quotas should not be used for controlling imports in crisis situations, but temporary added tariff rates should be the preferred method. The United States must consider the use of tariffs rather than quotas in bilateral negotiations which lead to orderly marketing agreements. Strict adherence to quotas does not allow the market mechanism to operate and in fact can enrich the foreign exporter at the expense of the U.S. consumer. It has been estimated, for instance, that Japanese automakers are earning anywhere from three-quarters to all of their profits in the United States, because of the quota limitations imposed upon them. On an annual basis, the FTC has estimated that quotas swelled the profits of Japanese companies by $824 million but by only $115 million for U.S. manufacturers. When a tariff is applied, the economic rent of higher prices is collected by the U.S. Government, not by the foreign manufacturer. If the foreign manufacturer wishes to maintain his market share or a new entrant wishes to begin operations here, the price effects of supply and demand can operate under tariffs--but not under a quota.

A-3. The United States must demand basic reciprocity and national treatment in trade and investments. Reciprocity here should be the natural outgrowth of an agreement to clear barriers and maintain open trading relationships. We should not unilaterally open our markets for some undefined benefit in the future.

National treatment assures no less favorable treatment for U.S. investors in a foreign nation than its own nationals enjoy. This is an important evidence of nondiscrimination. If a country does not allow private ownership of property or means of production, or restricts certain sectors to purely government ownership, its ability to freely invest in the United States can be handled case by case. The objective in both reciprocity and national treatment must be an ultimate opening of the other country's market, not a closing of ours. We should never recede into "tit for tat" revocations of previously agreed-to concessions. Yet there is no reason why the U.S. auto companies, for instance, had to struggle ten years to get minimal investments in Japan, while the Japanese had unequal access to the U.S. market. Likewise, in telecommunications trade, we do not have to unilaterally open our market to foreign competition without a compensating quid pro quo from other nations.

In pursuit of this objective, the government should use the powers contained in Section 301 of the Trade Act of 1974, as amended in 1984.

A-4. The United States should adhere to broad sector-by-sector negotiations so that industries of like value are treated equally. Thus, we should follow the policies set forth in the Trade Act of 1974. However, within broad sectors, both trade and investment should be considered together since one is closely related to the other with one-third or more U.S. exports, for instance, going to U.S. companies abroad. In addition, where trade and investment are a two-way street, problems in one area usually settle themselves out through earnings in the other. Today, however, some countries mount an export push while maintaining restrictive policies regarding foreign investments. When developed nations follow this practice, it maximizes foreign exchange earnings at the sacrifice of trading partners. The same behavior on the part of less developed countries is viewed as a stepping stone toward industrialization. However, once those nations emerge into the industrial world, the old policies never seem to change. By adhering to sector negotiations in meetings with countries that have newly "graduated" from LDC status, the United States can insist upon changes and hold out access to our markets as the carrot.

A-5. The United States must meet foreign export financing subsidies against competing U.S. export products where necessary in order to eliminate these measures. The availability of equal financing for U.S. products is a deterrent. While we should never strike first in providing outright subsidies to exports, we must always act in defense so that others can be persuaded of the futility of such practices.

A-6. The United States should initiate bilateral and multilateral agreements to phase out trade-distorting subsidies, and where agreement cannot be reached, take prompt and effective action on the subsidized imports. In this regard, we should refrain from using political considerations to balance economic problems.

A-7. Respect for international property rights should be buttressed with bilateral or multilateral agreements. We should not offer a country violating this principle automatic safeguards here in the United States. Ever since the establishment of the republic, Congress has been resolute in protecting property rights as they apply to our own jurisdiction. Ownership of patents should be defended because these technical frontiers may prove more important to our long-range welfare than physical plants. It is difficult to conceive of any machinery whereby we could impose comparable values on countries that do not share them. But we can encourage other countries to accept these principles by setting standards in trade legislation that authorizes our government's trade negotiations. As one of conditions of granting most-favored-nation access to our markets, we should adhere to the principle of protection or compensation for industrial property rights. This includes patents, trademarks, and proprietary technology or processes.

A-8. Performance requirements must be avoided on investments. Some nations accept investment only under strict conditions that a certain percentage of the output must be exported. These and other requirements can skew international trading relationships. The degree of access to the U.S. market should reflect the existence of such requirements and be part of our negotiating process. Where such requirements involve another government's promise to subsidize production or close local markets to competition, then the performance requirements are no different than subsidies which are actionable under international trade rules.

A-9. Domestic adjustment assistance to U.S. firms and workers adversely affected by import competition must be reshaped into a coordinated program to help firms redefine their operations and help workers retrain for marketable skills. These programs should be combined with unemployment payments where appropriate.

A-10. The United States must not make any changes in its domestic tax policies which disadvantage the earning of foreign exchange, reduce the repatriation of funds, or create a bias against exports. The Treasury Department's Tax Reform for Fairness, Simplicity and Economic Growth is not balanced in its treatment of foreign-source income. It will increase taxes on such income which will not add to economic growth. The choice is a basic one between investment for growth in a more stable future or current consumption without the necessary expansion of our asset base.

The overall method for computing foreign tax credits and the allocation rules for foreign sales income should be retained because changing them can reduce our exports. Our present export crisis is not the time to change rules which encourage these earnings. Also, changing the research and development tax credit would discourage domestic R&D while allocating R&D expenses to foreign-source income could push R&D facilities offshore. Spending on research and development is vital to our national security and industrial competitiveness. Elimination of the credit for domestic R&D will lower future foreign exchange earnings as the value added from the application of domestic R&D is whittled away by an offshore bias.

Finally, when there is a disparity between U.S. and foreign tax codes, and between U.S. tax treatment of foreign and domestic income, a serious problem arises for U.S. mining and material resource investment. We risk disadvantaging domestic activity in this area and reducing the foreign earnings of such activities when carried on as a branch operation.

B. Principles to be Considered

B-1. Countries with appreciating currencies should be able to use exchange-adjusted tariffs and, if necessary, rate equalization charges on financial flows. To maintain a competitive balance in trade flows based on product quality and actual costs when our currency appreciates rapidly from its purchasing power parity trend and creates a balance of payments disequilibrium, the United States should use Article XXIII of GATT on nullification and impairment. In our case, a large currency overvaluation effectively negates any tariff concessions received. Accordingly, tariff levels should be adjusted upward. Without effective coordination of fiscal and monetary policies among all industrial nations--an unrealistic prospect--it will be impossible for floating exchange rates to balance international trade flows and eliminate the arbitrary advantages of countries where currencies depreciate significantly more than competitive factors would dictate.[1]

The exchange adjustments envisioned here would restore true comparative advantage in the factors of production in a free trade regime. This correction would allow countries with appreciating or declining currencies to maintain their respective domestic policies. Moreover, it would not encourage the development of an unbalanced trade position that would force countries to seek protectionist quotas or marketing agreements. No country would have to pay for another's excesses, and the use of tariff adjustment rather than quotas would let the market mechanism determine trade flows without skewing market shares.

A 30 percent currency misalignment, combined with a persistent current account deficit,[2] as in the present situation favoring the yen, would give the United States the option to add that amount, or perhaps 80 percent of it, to its basic tariff rates on Japanese imports. When the yen-dollar relationship started to correct (or if the trade and current accounts moved back into line first), the tariff would be reduced to its original level. Changes in calculating the tariff charge could be made on a yearly basis.[1] Thus, the traded goods sector would not have to contend with daily changes.

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[1] This does not argue against better central bank coordination in the currency markets to stem speculative or other disorderly market conditions. However, such action cannot change the direction of basic economic forces on exchange rates and cannot be used to actually set a particular rate.

[2] When we have a current account deficit and a large trade surplus, maximum leeway should be used in assessing whether or not to use exchange-adjusted tariffs. Also, the current account must be precisely defined so that reinvested earnings and NATO expenditures do not skew our commercial balances.

Included with my testimony is an annex which outlines the criteria to be considered in any application of this proposal. This annex can be a starting point for consideration of this approach.

Floating exchange rates were supposed to achieve an equilibrium in the current account by equalizing national inflation rates. When exchange rates do not adjust for these differences, then our proposal would make the adjustment by affecting the trade account and ultimately the current account.

Thus, no undue trade advantage would be given to countries with internal policies that cause currency fluctuation. True comparative advantage in the factors of production could be followed with trade competition based on real economic differences.

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[1] The Finance Committee may want to ask the International Trade Commission to study this proposal and report its independent findings. IEPA staff resources do not allow for the development of alternative econometric models or formulas to quantitatively illustrate all of the details involved.

Some have argued that capital flows must also be adjusted by the use of controls.[1] However, for those who maintain that these flows must be regulated, we should be careful not to institutionalize capital controls by the depreciating currency country. To do so does not offer a market response and is akin to quotas in that the economic rent of the controls is reserved for the government or businesses of the country already receiving the trade benefits of depreciation. The effect is like the auto quotas which enriched Japanese car companies more than American ones. Instead, if adjustment of financial flows is felt to be warranted, then it should be through rate equalization charges levied by the appreciating currency country on the lender (i.e., the foreign supplier of funds) and not on the borrower (a U.S. citizen). The market system on allocation and pricing of funds would operate and the initial cost of funds to the borrower would be at his country market rates. The actual adjustment might be set at the difference between real interest rates in the foreign market, with perhaps an added historical markup such as 2 percent for the United States, and nominal rates in the U.S. In this way the flow of funds would be guided by the real economic return to be gained by investing in the U.S. rather than by very high nominal rates in the U.S.

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[1] See: C. Fred Bergsten in Current Exchange Rate Relationship of the U.S. Dollar and the Japanese Yen, Subcommittee on Trade, House Ways and Means Committee, November 1982, p. 28.

B-2. The United States should make use of Article XII of GATT on restrictions to safeguard the balance of payments. Where serious balance of payments difficulties arise, we should not be afraid to use internationally recognized corrective devices. Any necessary special measures should be temporary and not cemented in legislation. They should never be used to protect inefficient industries over a long term. The consultations required by Article XII could help us to bargain realistically with other countries, impress upon them the seriousness of our problems, and demonstrate our resolve to act with or without their help. In the past, Article XII has been used by several countries, including some in the reserve currency category. Britain, where the pound was considered a major reserve currency up to the 1970s, used Article XII on more than one occasion. France and Japan have also invoked its provisions, and the U.S. Government should not consider itself any "holier" than they. Under this article, the United States would be allowed to restrict the "quantity or value of merchandise permitted to be imported." In restricting the value of merchandise, we should apply a tariff rate quota across the board. The funds obtained from this measure (or from B-1 above) could be used to promote exports or meet foreign subsidies, especially where misalignment of currencies creates an overvalued dollar.

In joint consultations under GATT, we should explore the use of Article XII on a bilateral basis.[1] The changed circumstances in the world since GATT was written should be reflected. To reflect changing times, even our constitution, a most sacred document, has been amended in response to crises.

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[1] Unfortunately, Article XII only allows action across the board so its use would apply to countries where we do not have serious problems.

Mr. Chairman, I have appreciated the chance to give your Committee my views about what many regard as a critical problem. Some of my suggestions may seem unorthodox but they highlight my view that we cannot wait for reductions in our domestic budget deficit--as important as that is--to lower our interest rates and dollar exchange valuations. For that timing would probably be too little and too late for major sectors of the American economy.

Thank you for your attention. I would be pleased to respond to any questions the Committee may have.

ANNEX I

Definitions and Possible Criteria For the Use of Exchange-Adjusted Tariffs

I. Definition

A. The current account must be defined as those current U.S. transactions on trade in goods and services EXCLUDING:

1. Reinvested earnings--these are not inflows but are added to the government's current account figures and subtracted from the capital account. The overall effect is a zero-zero balance but the present effect on the current account is a fictitious positive inflow.

2. Net direct defense expenditures--these are a separate line item in the present current account. However, our NATO expenditures are so large in Germany, for instance, $3.7 billion in 1983, that this issue should be considered separately.

3. The trade effect of the special U.S.-Canadian auto agreement should be eliminated. As a separate agreement ratified by the Congress, its possible inclusion should only be by amendment to that agreement.

B. Misalignment of currencies shall be determined by using the real effective exchange rates--the index of the effective exchange rate adjusted for inflation differentials, measured by wholesale prices of nonfood manufactures. The effective exchange rate is the measure of a currency's trade-weighted average appreciation or depreciation vis-a-vis the currencies of 15 other major countries. An index would be used based upon March 1973 = 100. This is the same index used up to the summer of 1983 by Morgan Guaranty Trust Company in World Financial Markets.

C. The percentage of misalignment would be the full index point differential between the U.S. and the target country. To account for any possible errors, a 5 point leeway could be subtracted from this difference.

ANNEX I (continued)

II. Criteria

A. The following steps in order of listing would determine exchange-adjusted tariffs and their use. Such use would be on a country basis.

1. There must be a persistent current account deficit with the target country. "Persistent" would be classified as occurring over four consecutive quarters during one calendar year.

2. The current account deficit with the target country represents 20 percent of the U.S. total current account deficit for the year.

3. The percent of misalignment of both currencies would be determined.

4. When both 1 and then 2 are met, then 3 would be applied as an added tariff for a one-year period. Except that as a failsafe if:

   a. The U.S. subsequently experiences a current account surplus with the target country for one of the first two quarters after imposition of the extra tariff, AND

   b. The average exchange rate relationship readjusts to within 5 percent of parity, THEN

   c. The tariff would be dropped after the two quarters.

5. At the end of the year, a review would take place, starting with step II.A.1, then 2, and, if necessary, then 3 and 4.

TABLE I

U. S. NONMILITARY MERCHANDISE TRADE BY AREA, 1965-1983 (Balance of Payments Basis)

	TOTAL			CANADA			W. EUROPE			LATIN AMERICA			JAPAN			OTHER		
	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.
1965	26.5	21.5	5.0	5.7	4.8	0.9	8.9	6.2	2.7	4.2	4.4	- 0.2	2.1	2.4	- 0.3	5.6	3.7	- 1.9
1966	29.3	25.5	3.8	6.7	6.0	0.7	9.6	7.7	1.9	4.7	4.7	0.0	2.3	3.0	- 0.7	6.0	4.1	1.9
1967	30.7	26.9	3.8	7.3	6.9	0.4	9.7	8.1	1.6	4.7	4.7	0.0	2.7	3.0	- 0.3	6.3	4.2	2.1
1968	35.6	33.0	0.6	8.2	8.6	- 0.4	10.5	10.2	0.3	5.3	5.1	0.2	3.0	4.1	- 1.1	6.6	5.0	1.6
1969	36.4	35.8	0.6	9.1	9.9	- 0.8	11.6	10.2	1.4	5.5	5.2	0.3	3.5	4.9	- 1.4	6.7	5.6	1.1
1970	42.5	40.0	2.5	9.5	10.7	- 1.2	14.2	11.3	2.9	6.5	5.9	0.6	4.7	5.9	- 1.2	7.6	6.2	1.4
1971	43.3	45.6	- 2.3	10.9	12.2	- 1.3	13.6	12.8	0.8	6.5	6.1	0.4	4.1	7.3	- 3.2	8.2	7.2	1.0
1972	49.4	55.8	- 6.4	13.1	14.5	- 1.4	15.0	15.7	- 0.7	7.2	7.1	0.1	5.0	9.1	- 4.1	9.1	9.4	- 0.3
1973	71.4	70.5	0.9	16.7	17.7	- 1.0	21.2	19.8	1.4	10.0	9.6	0.4	8.4	9.7	- 1.3	15.1	13.7	1.4
1974	98.3	103.8	- 5.5	21.8	22.6	- 0.8	28.2	24.3	3.9	15.8	18.7	- 2.9	10.7	12.4	- 1.7	21.8	25.8	- 4.0
1975	107.1	98.2	8.9	23.5	21.9	1.6	29.9	20.8	9.1	17.1	16.2	0.9	9.6	11.3	- 1.7	27.0	28.0	- 1.0
1976	114.7	124.2	- 9.5	26.3	26.7	- 0.4	31.9	23.0	8.9	16.9	17.2	- 0.3	10.2	15.5	- 5.3	29.4	41.8	-12.4
1977	120.8	151.9	- 31.1	28.5	29.9	- 1.4	34.1	28.2	5.9	17.9	21.2	- 3.3	10.6	18.6	- 8.0	29.7	54.0	-24.3
1978	142.1	176.0	- 33.9	31.2	33.8	- 2.6	39.5	36.6	2.9	22.0	23.0	- 1.0	13.0	24.5	-11.5	36.4	58.1	-21.7
1979	184.5	212.	- 27.5	38.7	39.2	- 0.5	54.2	41.8	12.4	28.6	30.5	- 1.9	17.6	26.3	- 8.7	45.4	74.2	-28.8
1980	224.2	249.8	- 25.6	41.6	42.9	- 1.3	67.6	47.3	20.3	38.8	37.5	1.3	20.8	31.2	-10.4	55.4	90.9	-35.5
1981	237.0	265.1	- 28.1	46.0	48.3	- 2.3	65.1	52.9	12.2	42.8	39.1	3.7	21.8	37.6	-15.8	61.3	87.2	-25.9
1982	211.2	247.6	- 36.4	39.3	48.5	- 9.2	59.7	52.9	6.8	33.2	38.6	- 5.4	20.7	37.7	-17.0	58.3	69.9	-11.6
1983	200.3	261.3	- 61.0	43.8	54.4	-10.6	54.9	53.9	1.0	25.6	41.9	-16.3	21.7	41.3	-19.6	54.3	69.8	-15.5
1984	220.0	327.6	-107.6	53.1	68.7	-15.6	57.1	71.0	-13.9	29.8	48.0	-18.2	23.3	57.3	-34.0	56.7	82.6	-25.9

Source: Survey of Current Business, U. S. Department of Commerce, various issues.

TABLE II (a)
U. S. TRADE BY MAJOR CATEGORY

(millions of $)

	FOOD & LIVE ANIMALS			BEVERAGES & TOBACCO		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	2,388	3,052	- 664	442	313	129
1958	2,240	3,208	- 968	448	343	105
1959	2,405	3,173	- 768	447	407	40
1960	2,662	2,996	- 334	483	396	87
1961	2,916	3,018	- 102	506	437	69
1962	3,179	3,243	- 64	498	431	67
1963	3,565	3,401	164	531	462	69
1964	4,076	3,487	589	554	535	19
1965	4,003	3,460	543	517	553	- 36
1966	4,562	3,948	614	624	642	- 18
1967	4,061	4,003	58	649	698	- 49
1968	3,890	4,577	- 687	702	786	- 84
1969	3,733	4,531	- 798	714	778	- 64
1970	4,356	5,375	-1,019	702	855	- 153
1971	4,367	5,529	-1,162	709	876	- 167
1972	5,661	6,370	- 709	908	1,009	- 101
1973	11,930	8,015	3,915	1,008	1,221	- 213
1974	13,986	9,386	4,600	1,247	1,322	- 75
1975	15,484	8,503	6,981	1,308	1,420	- 112
1976	15,710	10,267	5,443	1,524	1,624	- 100
1977	14,116	12,558	1,558	1,847	1,669	178
1978	18,311	13,522	4,789	2,293	2,221	72
1979	22,245	15,170	7,075	2,337	2,565	- 228
1980	27,744	15,763	11,981	2,663	2,771	- 108
1981	30,291	15,238	15,053	2,915	3,138	- 223
1982	23,950	14,453	9,497	3,026	3,364	- 338
1983	24,166	15,412	8,754	2,813	3,408	- 595
1984	24,463	17,973	6,490	2,849	3,653	- 804

Source: *Overseas Business Reports* and *Survey of Current Business*, U. S. Dept. of Commerce, various issues.

TABLE II (b)
U. S. TRADE BY MAJOR CATEGORY
(millions of $)

	ANIMAL & VEGETABLE OIL & FATS			CHEMICALS		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	335	102	233	1,376	668	808
1958	272	98	174	1,425	789	636
1959	320	104	216	1,558	868	690
1960	307	95	212	1,805	821	984
1961	289	93	196	1,816	738	1,078
1962	314	98	215	1,883	772	1,111
1963	320	105	215	1,994	715	1,279
1964	414	119	295	2,364	702	1,662
1965	472	116	356	2,402	769	1,633
1966	357	146	211	2,675	955	1,720
1967	338	122	216	2,802	958	1,844
1968	274	158	116	3,287	1,129	2,158
1969	306	137	171	3,383	1,228	2,155
1970	493	160	363	3,826	1,450	2,376
1971	615	172	443	3,836	1,612	2,224
1972	508	180	328	4,133	2,015	2,118
1973	684	259	425	5,749	2,463	3,286
1974	1,423	544	879	8,819	4,018	4,801
1975	944	554	390	8,691	3,696	4,995
1976	978	464	514	9,959	4,772	5,187
1977	1,309	531	778	10,812	4,970	5,842
1978	1,521	511	1,010	12,623	6,430	6,193
1979	1,845	740	1,105	17,306	7,479	9,827
1980	1,946	533	1,413	20,740	8,583	12,157
1981	1,750	480	1,270	21,187	9,446	11,741
1982	1,541	406	1,135	19,891	9,494	10,397
1983	1,459	495	964	19,751	10,779	8,972
1984	1,922	696	1,226	22,336	13,697	8,639

Source: Overseas Business Reports and Survey of Current Business, U. S. Dept. of Commerce, various issues.

TABLE II (c)
U. S. TRADE BY MAJOR CATEGORY
(millions of $)

	CRUDE MATERIALS (INEDIBLE) OTHER THAN FUELS			MINERAL FUELS AND RELATED MATERIALS		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	2,533	2,766	- 233	1,814	1,556	258
1958	1,708	2,331	- 623	1,071	1,631	- 560
1959	1,823	2,907	- 1,084	853	1,568	- 715
1960	2,777	2,711	66	814	1,574	- 760
1961	2,765	2,485	280	763	1,725	- 962
1962	2,211	2,668	- 457	799	1,874	- 1,075
1963	2,476	2,673	- 197	945	1,914	- 969
1964	2,978	2,880	98	953	2,030	- 1,077
1965	2,856	3,103	- 247	947	2,221	- 1,274
1966	3,071	3,310	- 239	976	2,262	- 1,286
1967	3,284	2,997	287	1,104	2,248	- 1,144
1968	3,541	3,346	195	1,050	2,527	- 1,477
1969	3,569	3,460	109	1,130	2,794	- 1,664
1970	4,605	3,307	1,298	1,595	3,075	- 1,480
1971	4,329	3,382	947	1,497	3,715	- 2,218
1972	5,030	3,860	1,170	1,552	4,799	- 3,247
1973	8,380	5,014	3,366	1,671	8,173	- 6,502
1974	10,934	6,066	4,868	3,444	25,454	-22,010
1975	9,784	5,566	4,218	4,470	26,476	-22,006
1976	10,891	7,014	3,877	4,226	33,996	-29,770
1977	13,086	8,464	4,622	4,184	47,153	-42,969
1978	15,555	9,294	6,261	3,881	44,763	-40,882
1979	20,755	10,653	10,102	5,616	63,076	-57,460
1980	23,791	10,496	13,295	7,982	82,924	-74,942
1981	20,992	11,193	9,799	10,279	81,417	-71,138
1982	19,248	8,589	10,659	12,729	65,409	-52,680
1983	18,596	9,590	9,006	9,500	57,952	-48,352
1984	20,249	11,082	9,167	9,310	60,980	-51,670

Source: Overseas Business Reports and Survey of Current Business, U. S. Dept. of Commerce, various issues.

TABLE II (d)
U. S. TRADE BY MAJOR CATEGORY

(millions of $)

	MACHINERY			TRANSPORT EQUIPMENT		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	4,215	431	3,784	2,654	431	2,223
1958	3,894	483	3,411	2,496	670	1,826
1959	3,883	676	3,207	2,193	957	1,236
1960	4,308	724	3,584	2,704	742	1,962
1961	4,761	789	3,972	2,569	575	1,994
1962	5,217	954	4,263	2,840	720	2,120
1963	5,483	1,054	4,429	2,785	764	2,021
1964	6,525	1,314	5,211	2,844	902	1,942
1965	6,934	1,800	5,134	3,214	1,148	2,066
1966	7,678	2,688	4,990	3,478	2,135	1,343
1967	8,280	3,099	5,181	4,294	2,695	1,599
1968	8,844	3,772	5,072	5,603	4,215	1,388
1969	10,137	4,571	5,566	6,266	5,192	1,074
1970	11,685	5,375	6,310	6,197	5,798	399
1971	11,839	6,059	5,780	7,621	7,814	- 193
1972	13,566	7,916	5,650	7,951	9,504	- 1,553
1973	17,588	10,750	7,438	10,281	10,926	- 645
1974	24,318	11,811	12,507	13,871	12,251	1,620
1975	29,215	11,970	17,245	16,452	11,487	4,965
1976	32,113	15,446	16,667	17,388	14,378	3,010
1977	32,630	18,836	13,794	17,619	17,571	48
1978	38,105	24,752	13,353	21,163	22,838	- 1,675
1979	45,914	28,530	17,384	24,577	25,148	- 571
1980	57,263	32,286	24,977	27,366	28,260	- 894
1981	62,946	38,212	24,734	32,791	31,415	1,376
1982	59,324	39,457	19,867	27,824	33,863	- 6,039
1983	54,309	46,975	7,334	28,269	39,156	- 10,887
1984	60,318	68,345	- 8,027	29,655	50,802	- 21,147

Source: *Overseas Business Reports* and *Survey of Current Business*, U. S. Dept. of Commerce, various issues.

TABLE II (e)
U. S. TRADE BY MAJOR CATEGORY

(millions of $)

	MANUFACTURED GOODS			OTHER TRANSACTIONS		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	4,349	[illegible]	807	475	362	113
1958	3,731	3,342	389	466	325	141
1959	3,537	4,589	- 1,052	431	380	51
1960	4,076	4,559	- 483	450	401	49
1961	3,891	4,421	- 530	476	435	41
1962	3,972	5,180	- 1,208	518	440	78
1963	4,349	5,532	- 1,183	615	517	98
1964	4,795	6,188	- 1,393	794	591	203
1965	4,890	7,528	- 2,638	954	730	224
1966	5,388	8,668	- 3,280	1,187	866	321
1967	5,468	9,004	- 3,536	959	1,065	- 96
1968	6,084	11,208	- 5,424	924	1,028	- 104
1969	7,000	12,020	- 5,020	1,224	1,332	- 108
1970	7,636	13,285	- 5,649	1,496	1,274	222
1971	7,147	14,929	- 7,782	1,531	1,476	55
1972	8,094	18,332	-10,238	1,560	1,598	- 38
1973	11,113	21,461	-10,348	1,842	1,794	48
1974	16,515	27,145	-10,630	2,587	2,256	331
1975	16,592	23,927	- 7,335	3,162	2,518	644
1976	17,781	30,180	-12,399	2,749	2,538	211
1977	19,091	35,176	-16,085	4,314	3,358	956
1978	22,644	46,296	-23,652	5,030	4,018	1,012
1979	28,879	51,070	-22,191	9,103	4,905	4,198
1980	38,602	55,901	-17,299	8,496	7,183	1,313
1981	37,379	63,471	-26,092	8,389	7,296	1,093

	MANUFACTURED GOODS & OTHER TRANSACTIONS		
	EXP.	IMP.	BAL.
1982	39,543	68,917	-29,374
1983	37,106	74,281	-37,175
1984	40,932	98,588	-57,656

Source: *Overseas Business Reports* and *Survey of Current Business*, U. S. Dept. of Commerce, various issues.

TABLE III

U. S. TRADE BALANCE, OFFICIAL CURRENT ACCOUNT AND CURRENT ACCOUNT ON ACTUAL TRANSACTIONS[1], OVERALL, 1960-1970, (in millions of $)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
U.S. Overall Trade Balance	4,892	5,571	4,521	5,224	6,801	4,951	3,817	3,800	635	607	2,603
Official Current Account	1,732	3,005	2,404	3,143	5,718	4,251	1,582	1,215	-1,374	-2,017	-356
Overstatement of[2] Net Reinvested Earnings	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Current Account on Actual Transactions	1,732	3,005	2,404	3,143	5,718	4.251	1,582	1,215	-1,374	-2,017	- 356

(footnotes attached)

TABLE III

U. S. TRADE BALANCE, OFFICIAL CURRENT ACCOUNT AND CURRENT ACCOUNT ON ACTUAL TRANSACTIONS[1] OVERALL, 1971-1984, (in millions of $)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
U. S. Overall Trade Balance	-2,260	-6,416	+ 911	-5,505	+ 8,903	-9,483	-31,091	-33,966	-27,555	-25,512	-28,001	-36,469	-61,055	-107,600
Official Current Account	-1,433	-5,795	+7,140	+1,962	+18,116	+4,207	-14,511	-15,446	- 964	+ 1,898	+ 6,294	- 9,199	-41,563	-101,647
Overstatement of Net Reinvested Earnings[2]	(+2,635)	(+3,963)	(+7,248)	(+6,712)	(+ 6,859)	(+6,037)	(+ 4,810)	(+ 8,760)	(+15,010)	(+10,850)	(+ 8,879)	(+ 7,665)	(+ 7,733)	(+ 8,249)
Current Account on Actual Transactions	-4,068	-9,758	- 108	-4,750	+11,257	-1,830	-19,321	-24,206	-15,974	- 8,952	- 2,585	-16,864	-49,296	-109,896

(footnotes attached)

TABLE III

Footnotes:

1/ Current Account on Actual Transactions represents the balance of actual imports and exports of goods and services. It is the current expenditure of dollars on all imports minus the earning of foreign exchange from all exports and includes the balance on goods and services and unilateral transfers but excludes accounting gimmicks as outlined in footnote 2.

2/ Reinvested earnings of American companies abroad are included in the government current account figures *as if they were an inflow of funds*, thus inflating our exports of goods and services. *These monies are not an actual inflow* of funds, of course, since they are earned abroad, taxed abroad and used abroad. In the U.S. Official Capital Account the exact same "inflow" is subtracted as an outflow so the total effect on our complete payments accounts is zero. The reverse of the above is true for reinvested earnings of foreign companies here in the United States. The figure on this line represents the difference between the fictitious export and import of these funds. A (+) represents the net amount that must be subtracted from the official current account; a (-) represents the amount that must be added.

NA - Not applicable. In earlier years, reinvested earnings were never included in the current account. The change to include them on the plus side of the current account and below the line on the negative side of the capital account occurred in 1977. U.S. accounts *since then* have been restated back to 1971 and have overstated the actual balance in foreign exchange terms.

SOURCE: *Survey of Current Business*, U.S. Department of Commerce, various issues.

TABLE IV

MANUFACTURING PRODUCTIVITY -- OUTPUT/HOUR
(annual percentage change)

YEAR	U.S.	JAPAN	FRANCE	W. GERMANY	U.K.
1960-83	2.6	9.1	5.8	5.0	3.5
1960-73	3.0	10.7	6.7	5.7	4.4
1973-83	1.9	7.3	4.6	3.3	1.9
1980	0.2	9.5	1.5	1.4	-1.0
1981	3.1	5.5	2.6	1.8	5.9
1982	2.1	8.1	5.6	1.2	3.9
1983	4.3	5.0	5.9	4.7	6.6
1984	4.8 est.				

Source: Bureau of Labor Statistics

OVERALL U.S. PRODUCTIIVITY -- OUTPUT/HOUR
(annual percentage change)

1965	3.0	1975	2.2
1966	3.5	1976	3.3
1967	2.1	1977	2.4
1968	2.7	1978	0.5
1969	0.0	1979	-1.2
1970	0.8	1980	-0.5
1971	3.6	1981	1.9
1972	3.5	1982	0.2
1973	2.6	1983	2.7
1974	-2.4	1984	3.2

Source: CEA Economic Indicators

TABLE V (a)

U.S. TRADE AND CURRENT ACCOUNT[1] BALANCES BY SELECTED AREAS
(millions of $)

Year	WESTERN EUROPE		LATIN AMERICA AND OTHER WESTERN HEMISPHERE		ASIA AND AFRICA[2]	
	Trade	Current	Trade	Current	Trade	Current
1960	2,549	232	-194	276	794	- 34
1961	2,787	795	22	615	1,038	124
1962	2,602	833	-316	298	1,413	719
1963	2,881	1,057	-398	215	1,649	1,059
1964	3,378	1,866	74	806	1,682	1,215
1965	2,686	1,078	-122	586	1,400	938
1966	1,914	179	38	1,006	1,590	240
1967	1,581	51	18	1,063	1,826	218
1968	342	-1,465	153	1,493	1,256	185
1969	1,402	-1,230	324	1,312	745	- 12
1970	2,886	-1,092	603	1,420	961	451
1971	779	-2,238	346	1,274	400	-205
1972	-667	-5,037	162	713	-1,033	-1,154
1973	1,457	-4,169	316	1,600	- 398	1,625
1974	3,897	-1,000	-2,838	-853	-6,684	-6,358
1975	9,120	5,690	931	4,604	-4,922	-1,721
1976	8,880	6,646	-337	3,951	-16,755	-11,879
1977	5,868	4,210	-3,243	1,900	-26,486	-19,981
1978	2,928	1,627	-1,008	5,692	-23,181	-16,530
1979	12,351	13,836	-1,980	6,366	-31,527	-24,531
1980	20,348	19,102	1,320	12,347	-37,520	-33,386
1981	12,235	9,656	3,705	20,100	-32,260	-26,085
1982	6,793	3,101	-5,407	8,021	-16,888	-11,750
1983	981	-6,391	-16,286	-8,163	-18,453	-14,088
1984	-13,943	-27,904	-18,198	-13,425	-30,182	-27,482

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[1] This includes reinvested earnings which are not really inflows.

[2] Excluding Japan and South Africa.

Source: Survey of Current Business, various issues

TABLE V (b)

U.S. TRADE AND CURRENT ACCOUNT[1] BALANCES WITH SELECTED COUNTRIES

(in millions of $)

	CANADA		UNITED KINGDOM	
Year	Trade	Current	Trade	Current
1960	861	1,054	466	141
1961	625	965	294	85
1962	393	685	147	-74
1963	388	596	173	-31
1964	593	1,177	468	360
1965	642	1,401	216	92
1966	801	1,753	-24	-171
1967	448	1,053	162	166
1968	-442	373	-86	-248
1969	-812	44	-42	-758
1970	-1,645	-580	329	-484
1971	-1,760	-453	-73	-779
1972	-1,972	-426	-214	-975
1973	-984	676	232	-507
1974	-550	1,541	583	-240
1975	1,827	6,673	1,144	258
1976	-139	5,814	941	- 1
1977	-1,112	4,938	900	754
1978	-2,323	4,704	802	893
1979	- 330	8,720	2,677	6,316
1980	-1,277	7,315	2,970	5,602
1981	-2,242	7,174	-263	3,859
1982	-9,323	98	-2,352	-841
1983	-10,546	551	-2,008	-1,993
1984	-15,534	-5,071	-2,297	

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[1] This includes reinvested earnings which are not really inflows.

Source: Survey of Current Business, various issues.

TABLE V (c)

U.S. TRADE AND CURRENT ACCOUNT[1] BALANCES WITH SELECTED COUNTRIES
(millions of $)

	GERMANY		FRANCE		MEXICO	
	Trade	Current	Trade	Current	Trade	Current
1968	-1,085	-1,679	233	229	468	390
1969	- 622	-1,299	386	303	422	391
1970	- 506	-1,270	596	439	483	407
1971	1,121	-1,897	316	206	357	186
1972	-1,546	-3,101	251	103	353	32
1973	-1,841	-3,860	581	333	655	338
1974	-1,615	-3,301	670	522	1,469	1,335
1975	- 306	-1,684	962	1,164	2,107	2,459
1976	- 177	- 620	-1,031	1,088	1,412	1,223
1977	-1,399	-2,576	490	674	140	- 52
1978	-2,766	-3,918	190	684	595	644
1979	-2,259	-4,236	850	1,110	1,130	1,785
1980	- 243	-3,167	2,277	2,721	2,647	4,790
1981	- 887	-4,192	1,592	1,145	4,440	8,807
1982	-2,689	-5,866	1,661	1,827	-3,820	-1,956
1983	-4,284	-9,606	-39	-172	-7,693	-6,677
1984	-7,945		-1,925		-6,002	

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[1] This includes reinvested earnings which are not really inflows.

Source: Survey of Current Business, various issues.

TABLE VI

U.S. TRADE AND OFFICIAL CURRENT ACCOUNT BALANCES WITH JAPAN, 1960-1984

(in millions of $)

Year	U.S. Trade Balance with Japan	Current[1] Account with Japan
1960	225	-108
1961	710	454
1962	180	- 52
1963	320	105
1964	200	86
1965	-388	-505
1966	-634	-915
1967	-345	-587
1968	-1,120	-1,384
1969	-1,416	-1,777
1970	-1,244	-1,541
1971	-3,225	-3,475
1972	-4,113	-4,821
1973	-1,309	-1,463
1974	-1,690	- 944
1975	-1,690	-1,220
1976	-5,335	-5,405
1977	-7,999	-8,126
1978	-11,581	-11,791
1979	-8,632	-8,746
1980	-10,411	-8,917
1981	-15,882	-13,923
1982	-16,991	-15,478
1983	-19,630	-18,332
1984	-34,024	-35,176

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[1] This includes reinvested earnings which are not really inflows.

Source: Survey of Current Business, various issues.

STATEMENT OF SAUL SROLE, ECONOMIST, WASHINGTON, DC

The CHAIRMAN. Mr. Srole.

Mr. SROLE. Mr. Chairman, a floating exchange rate, open trade in the market for exchange, is a means to an end. The United States views it as serving the same basic end as open trade in the market for goods. Both are thought efficiently to allocate resources by prompting countries to make and trade their comparative advantage goods. This is the notion of the market economy.

Invariably overlooked, but crystal clear in the economics literature, is that open trade in goods is by itself adequate to its end only under barter. Only under barter will the open trade by itself cause countries to make and trade their comparative advantage goods. Under exchange use, there must be an exchange rate that translates the goods' internal price to a competitive external price. The rate would derive, thus, from countries' price relationships, and tend to approximate their average, like a purchasing power parity rate.

As a guide to rate policy, economists have little use for a purchasing power parity rate. Perceiving its negative aspect—the problem of computing it—economists have not perceived its positive aspect, that is, that a country's export of its comparative advantage goods, and import of others' such goods, is abetted by a purchasing power parity rate.

The floating dollar rate has for 12 years stood either well over or well under its purchasing power parity rate, being in these terms misvalued. Since 1981, it has been overvalued, curbing the export of U.S. comparative advantage goods, for example, high-tech goods, farm products, while spurring the import of others' noncomparative advantage goods, for example, electronics, chemicals. It acted as an export restraint and import subsidy.

During 1973–75 and 1978–80, it conversely was undervalued and acted as an import restraint and export subsidy. The floating dollar almost always played the part of a trade restraint and subsidy, the antithesis of the policy of open trade in goods. Open trade in exchange didn't serve the same end as open trade in goods. It didn't bring trade in comparative advantage goods promised by open trade in goods, and hasn't efficiently allocated resources.

In a lecture given during late 1978, Paul Volcker as head of the New York Federal Reserve Bank stated that: "When patterns of trade become influenced by * * * [exchange rate] fluctuations rather than lasting comparative advantage, the underlying rationale of [open] trade is undercut." Speaking to a convention of the National Foreign Trade Council, Mr. Volcker decried the fact that "swings so large as we've seen in key exchange rates can have little to do with comparative advantage and the efficient allocation of resources."

In sum, what our policy of open trade in goods has tried to do, our policy of open trade in exchange has worked to undo. Open trade in goods was diminished, its end imperiled.

Backers of the floating dollar would declare that if countries had convergent economic policies aimed at stable prices, the floating rate would itself approximate the purchasing power parity rate. But convergent economic policies in a world of divergent political priorities is not apt to occur. Besides, economic policies can't fine tune economic events, especially in the short run, when there are influences that defy policy reach. A rate policy dependent for success on something not apt to occur lacks merit.

In a world of heterogeneous political priorities and imperfect policy tools, the maintenance of a purchasing power parity rate as a market rate would call from time to time for intervention. Proponents of a floating rate would declare that intervention couldn't work.

However, it did work under the Bretton Woods system until the mid-1960's, when intervention preserved a stable dollar rate that had become overvalued because there had been a sharp drop in the dollar's purchasing power parity rate. It could have worked with intervention targeted toward a purchasing power parity rate. This circumstance would allow it to work.

A reason it could work, then, is that a currency's market rate is subject to the magnetic pull of its purchasing power parity rate, an economic fundamental that reflects countries' price relationships. There would be less cause for intervention if done in behalf of such a rate. The prospect of coordinated intervention to yield a purchasing power parity rate would likewise mean less cause for intervention. Speculative capital flow, reacting to the prospect, would help establish or maintain the rate at its purchasing power parity point.

Still another reason intervention could work is that whatever amount had to be, could be mustered. A central bank can create domestic currency almost without limit. Thus, it can sell the currency almost without limit to dampen or reduce its exchange value. By the same token, a sister central bank can buy the currency almost without limit to sustain or increase its exchange value. As required, the currency's exchange value could be controlled by intervention. Private capital flow can be neutralized in its exchange value effect by official capital flow, which intervention represents.

Changes in currency aggregates resulting from intervention in exchange markets can be reversed, as advisable, by operations in money markets. Experience suggests that currency aggregates do not have to be influenced by intervention activity.

A fall in the dollar's external value will not bring an equal rise in the price of U.S. imports, with its potential for renewed inflation. When the dollar strengthened and foreign currencies became worth fewer dollars, producers abroad often raised prices in their own currency, and held dollar prices firm to enlarge their profit. With a dollar that weakens, hence with foreign currencies worth more dollars, producers abroad could afford to lower prices in their currencies, and hold dollar prices firm to stay competitive.

Purchasing power parities for most countries would not be too hard to estimate, at least for practical purposes. To establish and maintain exchange rates at purchasing power parity value, reflecting countries' price relationships, would avert trade imbalances due to shifting price relationships. Trade imbalances could however come from other causes. When there are others—differential phases of the business cycle, differential economic development, shifting consumer preferences, lagging competitive effort, crop failures or other natural disasters, dock strikes or other work stoppages, et cetera—trade imbalances would have to be dealt with as appropriate by dealing with the causes.

There's no need for them to be dealt with by exchange rate adjustment that diverts a rate from its purchasing power parity value. Allowing a rate to stray from there on behalf of trade balance, besides the lack of need, would misallocate resources. The rate would become inconsistent with goods open trade. A rate consistent with the open trade, approximating a purchasing power parity rate, is a viable policy. For the United States and the rest of the free world pledged to the open trade, it's fitted to the open trade, and without which the open trade loses substance.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Srole follows:]

PREPARED STATEMENT OF SAUL R. SROLE

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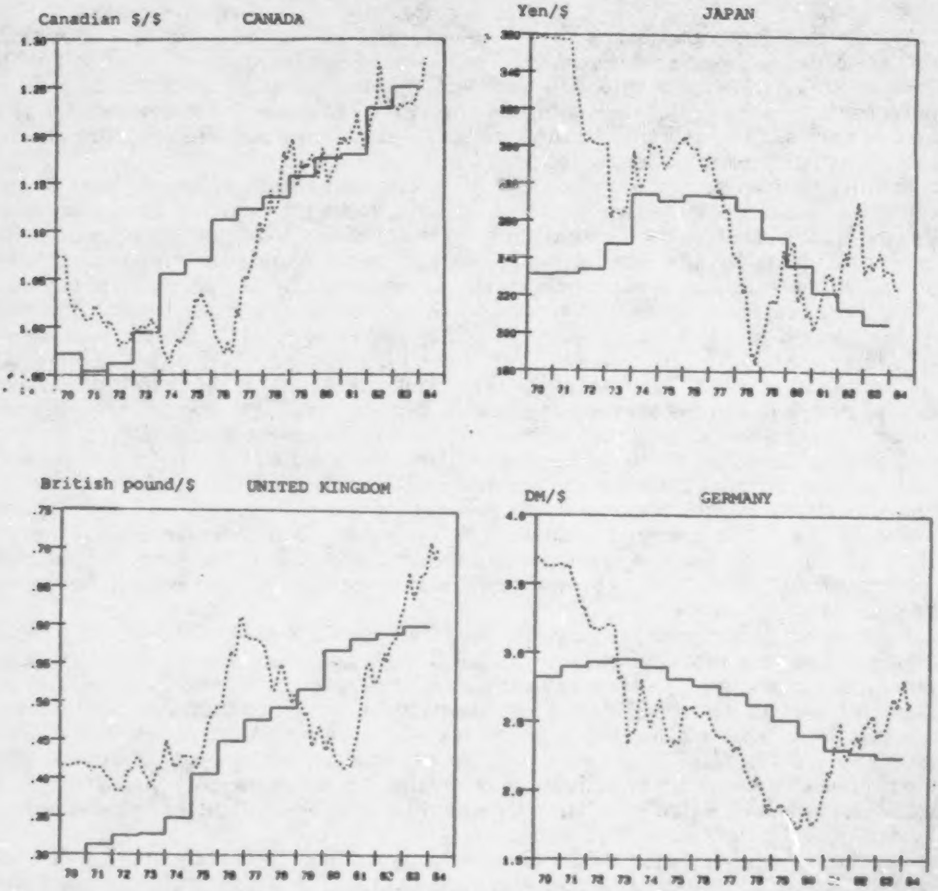
Purchasing Power Parity (PPP)
and Market Exchange Rates
(foreign currency/U.S. $)



PPP Rates (solid line): BLS unpublished compilation of purchasing power parity exchange rates, based on the Report of the United Nations International Comparison Project: Phase III.

Market Rates (dots): Monthly average of daily foreign currency per dollar exchange rates. A rise indicates a stronger dollar.

**Purchasing Power Parity (PPP)
and Market Exchange Rates
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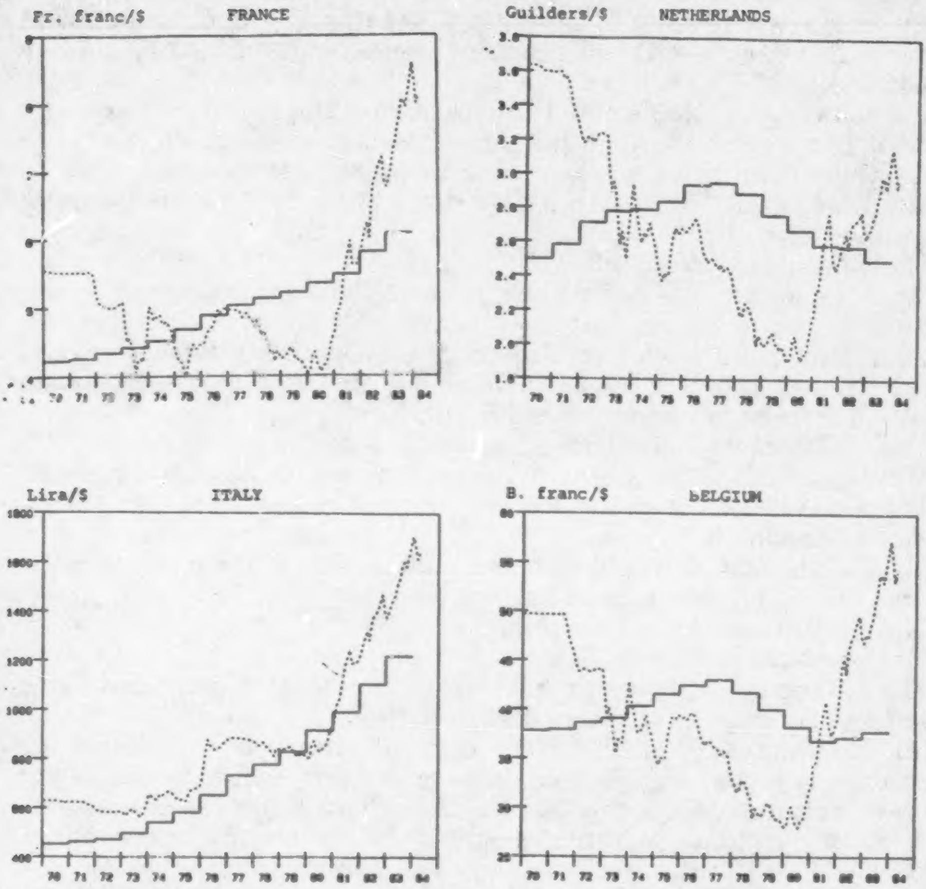

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The CHAIRMAN. Mr. Danielian, in your statement you indicated that in order to open foreign markets to us we had to—I didn't understand this—you said retaliate. What was your word?

Mr. DANIELIAN. No. To maintain open markets, we have to use a conditional most-favored-nation status to bargain with foreign countries. And where we reach agreements, only those countries with which we reach an agreement obtains the concession. And those with which we do not reach agreements do not. Very similar to the Tokyo-MTN round.

The CHAIRMAN. You know the frustration that most of the members of this committee are having with Japan. What do we do to make them open their markets to some significant degree?

Mr. DANIELIAN. Well, I think we don't blink first at the bargaining table.

The CHAIRMAN. We don't what?

Mr. DANIELIAN. We don't blink first at the bargaining table. Unfortunately, there may be times when the situation persists for such a long time that the United States has to take action and insist that their markets be open or our markets will correspondingly have to be adjusted toward them.

The CHAIRMAN. You mean closed or limited.

Mr. DANIELIAN. Yes. Some arrangement would have to be made.

The CHAIRMAN. Selective tariffs, quotas, whatever it might be aimed at Japan.

Mr. DANIELIAN. I would not use quotas, Mr. Chairman, because quotas do not let the market system operate.

The CHAIRMAN. An action aimed at Japan?

Mr. DANIELIAN. Yes.

The CHAIRMAN. It doesn't have to be aimed at Korea and Hong Kong and Singapore. It's aimed at Japan.

Mr. DANIELIAN. Well, if in the current situation you would use exchange adjusted tariffs, and have a criteria where a persistent current account deficit must exist and where it represents a large portion of our total current account deficit with any one country, Japan would fall into that category, Mr. Chairman.

The CHAIRMAN. I'm not thinking so much—you know, the current account deficit, they may open their markets and the current account deficit may be bigger for all I know. I don't know how much we will sell the—given totally open markets—how much they would sell here given totally open markets. And the Lord knows our markets are not totally open.

I'm not sure the criteria ought to be the trade deficit. The criteria ought to be, will they open their markets? And I'm just trying to find out what kind of a club or hammer we use if they won't.

Mr. DANIELIAN. Well, I'm not wedded necessarily to the criteria I used in my annex on page 35 of my full statement. There could be other criteria. It could be changed. You might explore using trade, although you really do have to look at the total current account transactions with the country because investment comes in there and trade and investment are the flip side of the same coin. Thirty-three percent of U.S. exports go to American investments abroad.

So you've got a symmetry there. I think it would be a little difficult just to separate out trade, but I'm not necessarily wedded to it.

I'm throwing out an idea that might want to be studied in various forms.

The **CHAIRMAN**. Bill?

Senator **BRADLEY**. Thank you, Mr. Chairman.

Let me ask you, Mr. Danielian, I take it from your testimony that you would like to see us bargain hard with the rest of the world. Is that right?

Mr. **DANIELIAN**. I think we have to. We have a foreign exchange shortage.

Senator **BRADLEY**. And do you think that we should do that on a bilateral basis with each country or do you think that we should continue with the support for the multilateral approach?

Mr. **DANIELIAN**. I think we have to have support for the multilateral approach. But within that approach we can act bilaterally—and we are doing it right now, frankly, even under GATT. We are acting on a bilateral basis, Either with groups of countries or with one country. I believe that's the approach the USTR is now taking, even though it's under a multilateral umbrella.

Senator **BRADLEY**. That's true.

Could you tell me, if you were going to advise us as to three things that we should do legislatively, what are the three things that you would suggest?

Mr. **DANIELIAN**. Well, the budget deficit is extremely important.

Senator **BRADLEY**. All right. Two?

Mr. **DANIELIAN**. The second is, I think, that we have to make greater use of section 301 in the Trade Act, as amended by this committe last year.

Three, I think that coordinated intervention in the currency markets will enable us to flatten some of the peaks and valleys in currency fluctuation. I do not believe that you can adjust the currency by 20 or 30 percent through exchange intervention. But certainly a closer coordinated effort on the part of central banks around the world would help.

Senator **BRADLEY**. All right. Your three are deficit reduction, greater use of expanded section 301 action, and intervention.

Mr. **DANIELIAN**. That's correct.

Senator **BRADLEY**. What would yours be, Mr. Srole?

Mr. **SROLE**. Beg your pardon?

Senator **BRADLEY**. What would your three recommendations to this committee be, what actions?

Mr. **SROLE**. My recommendation would be to have an exchange rate policy consistent with our trade policy. In concrete terms that means having a market rate about equal to a currency's purchasing power parity rate, reflecting inter-country price relationships.

A rate like this would avert trade or current account imbalance that comes from other than shifts in price relationships. When imbalance has a different cause, you would take action, geared to the cause, as appropriate.

Should a dock strike or a crop failure, or matters like that, constitute the cause, there would be no action appropriate.

Senator **BRADLEY**. Do you think we need to get the deficits down?

Mr. **SROLE**. I don't think this is especially relevant.

Senator **BRADLEY**. You don't think it's relevant.

I've found the man, Mr. Chairman.

Mr. **Srole**. It is not especially relevant. If we adopt the policy—you may want to call it a par value system—of having a par value rate that matches a currency's purchasing power parity rate, and if this is announced to the world, it wouldn't be necessary to get deficits down, likewise interest rates, in order to get dollar rates down. If, for instance, our purchasing power parity rate is 20 percent below the dollar's market rate, and it's recognized that central banks are determined to weaken the dollar by 20 percent through intervention, then capital flow will act to weaken the dollar because everybody is going to want to sell dollars before the 20 percent drop occurs. The gain from holding dollars that earn high interest rates would be more than offset by the loss from the dollar's eroded exchange value.

Given a target rate consistent with our trade policy, and given that central banks would coordinate intervention toward the target rate, there would be little call for intervention—official capital flow. Private capital flow would do the job instead. Insofar as there is trade or current account imbalance, you would adjust your action to the cause of imbalance. You would not adjust the exchange rate, except to compensate for altered price relationships, enabling you to have an exchange rate policy consistent with our trade policy instead of inconsistent with it, as it is at the present time.

Senator **Bradley**. Thank you very much.

The **Chairman**. Gentlemen, thank you very much. We are adjourned.

[Whereupon, at 4:01 p.m., the hearing was recessed, to convene at 9:30 a.m., Wednesday, April 24, 1985.]

[The following statement was submitted and was made a part of the hearing record:]

PREPARED STATEMENT OF JACQUES DELORS, PRESIDENT OF THE COMMISSION OF THE EUROPEAN COMMUNITIES

Over the last 2 years the performance of the U.S. economy, with a strong growth of output, low inflation and a sharp decline in unemployment, has been quite impressive and has undoubtedly fuelled the recovery of world trade. At the same time, the U.S. policy-mix has led practically everywhere to very high real interest rates, to an important growth differential vis-a-vis other industrial countries and to spectacular distorsions in exchange rates. It has also led the U.S.A. into a position of net debtor vis-a-vis the rest of the world. As a result, the U.S. economy is progressively feeling the consequences of a number of unsustainable, interrelated developments: growth is decelerating, imports are soaring, unemployment has levelled off, protectionist pressures are strongly increasing, etc. . . . This situation and its resolution, is of immediate concern to the rest of the world and in particular to Europe.

At the same time industrialised countries are embarking upon the preparation of a new round of multilateral trade negotiations. The European Community feels strongly committed to the objective of a new GATT round. It should however be made very clear that the fundamental issues which the main industrialised countries must face go far beyond the mere preservation of freetrade: indeed the economy of the western world is fraught at present with a number of imbalances, the correction of which is a prerequisite for a long-lasting, sustainable pattern of international economic and monetary relations. Three conditions will have to be met if the problems are to be adequately addressed: exchange rates must return to a more sustainable pattern, interest rates must be more condusive to long-term real growth and a better balance of growth must be found between the U.S.A. and the other industrial countries.

EXCHANGE RATES AND TRADE

The high dollar has recently become a cause of widespread and immediate concern in America. In real effective terms the dollar appreciated by nearly 40 percent between 1970 and late 1984 and there are increasing doubts as to whether the U.S. economy can withstand such a large appreciation. The problems raised by this evolution of the dollar typically illustrate a fundamental malfunctioning of the present international monetary and trade system: the fact that currencies can fluctuate widely and reach levels which are impossible to explain in terms of economic fundamentals necessarily has adverse consequences on world trade.

Exchange rate uncertainty and volatility directly affect the volume of trade by making prices and profits very uncertain and by requiring expensive hedging operations. They also tend, in the long run, to discourage international trade. On the other hand a strongly overvalued currency tends to induce an excessive export bias in the productive capacities of other countries, which will increase competitive pressure in the short run and feed protectionist reactions when exchange rates are corrected. Finally the present situation of the U.S. dollar to some extent prevents a more appropriate evaluation of the yen, and thus, tends to exacerbate the problem which the Japanese current account surplus raises not only for America but also for Europe. All these reasons point to the fact that more sustainable and predictable exchange rates would contribute to a more balanced development of world trade.

INTEREST RATES AND LONG-TERM GROWTH

U.S. interest rates remain today—even after a decline since mid-1984—at very high levels, especially in real terms; and, despite their efforts, European countries have managed only to a limited extent to decouple their interest rates. This situation has well known far-reaching consequences both in industrialised countries and in developing countries. The most worrying ones are probably for the long run; persistently high real interest rates inevitably tend to hamper real growth. True, the U.S. experience since 1983 shows that an investment boom is possible with high real interest rates; but this boom has been fueled by specific factors (fiscal policy for instance) which cannot be easily reproduced. The long term effects of high real interest rates on real growth in industrialised countries inevitably undermines the prospects for world trade.

GROWTH IN THE U.S.A. AND OTHER INDUSTRIAL COUNTRIES

Several strategies are open to reduce exchange rate misalignments and to provide the conditions for a gradual decrease of interest rates. They range from pure benign neglect (hoping for an automatic correction of the problems) to general or targeted protectionist measures (the surest way towards an overall contraction of world trade), via a severe stabilization policy in the U.S.A. (which would have far-reaching damaging consequences for the world economy). Almost no strategy will achieve substantial results without a deliberate and efficient U.S. policy bringing substantial reduction in the Federal Budget deficit. Because of the acuteness of the problem posed by the U.S. current account deficit, there is a risk of unilateral action, implementing a mixture of the strategies referred to above: This would lead to a sharp deceleration of growth on an international level.

It would however be wrong to believe that the imbalance between investment and savings in the U.S. economy, whatever its wideranging consequences, is at the origin of all our difficulties. Severe problems lie elsewhere too: in Japan, as reflected by a formidable trade surplus, and in Europe, as reflected by a low growth and persistently high unemployment. We believe that the case for an internationally coordinated strategy is over-riding. It should encompass corrective measures on the U.S. side, with credible action on the budget to start with, but also measures in Japan and in Europe in order to prevent a new world recession. The nature of such measures has to be well-designed to fit the particular situation of each country. It is, in particular, often heard on the U.S. side that the problem of European economies would be solved if the U.S. "cure" was adopted. Nothing is more misleading and more questionable. First, European countries cannot afford the fiscal boost which was at the origin of the strong U.S. recovery since 1982, and even if they could, the consequences on interest rates, including those for the U.S. economy, would be intolerable. Secondly, although structural weaknesses in European economies remain pronounced, a pure supply-side shock would be simply impossible because values, attitudes and social structures are fundamentally different in Europe.

FINAL REMARK

A multi-pronged and internationally well-coordinated strategy—including a new GATT round—becomes urgently necessary today to cope with the dangerous imbalances in the world economy. The Bonn summit will provide an opportunity for a first discussion on the principles and objectives of such a cooperative action, one in which Europe is surely prepared to make its full contribution.

FLOATING EXCHANGE RATES' IMPACT ON INTERNATIONAL TRADING

WEDNESDAY, APRIL 24, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Heinz, Symms, Grassley, Long, Bentsen, Moynihan, Baucus, and Bradley.

Also present: Mr. Leonard Santos, trade counsel.

The CHAIRMAN. Folks, let's get started. To encourage brevity, I'm going to skip any opening statements this morning because we have a long list of witnesses, and important witnesses. And I'm hoping we can finish without having to go into the afternoon.

Senator Bentsen, do you have any opening statement?

Senator BENTSEN. I'm going to follow your sterling example, Mr. Chairman.

The CHAIRMAN. In that case, I will start this morning with Mr. Galvin, the chairman of the board and the chief executive officer of Motorola. Mr. Galvin is a man well known to this committee who has appeared before us before, and whose judgment we place in high regard.

Welcome.

STATEMENT OF ROBERT W. GALVIN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, MOTOROLA, INC., SCHAUMBURG, IL

Mr. GALVIN. Thank you, both you gentlemen, and thank you for the privilege of appearing personally.

The thrust of my brief extemporaneous comments will be an effort to punctuate the urgency of the situation as far as industry is concerned. Sometimes a little anecdote helps to bring the matter to life.

We are a high technology company. I think we are a reasonably successful one. We do most of the things that you urge a good competitor should do.

At the present time, we are erecting facilities around the world. Approximately one-third of the places where we are erecting facilities are outside of the country.

We are designing facilities that should be erected in a year or two or three. One-half of the locations where we will place those facilities are outside of the United States.

We are in the process of seeking out new locations for facilities. One must plan ahead. Two-thirds of the locations where we are looking for the placement of our business are outside the United States.

This is an illustration of the rapid pace with which American industry is obliged to respond to the totality of the competitive situation and environment in which we operate. To make it picturesque, American industry is defecting from the United States.

I come here literally as a person with two roles. First, as the chief executive of our company and a privileged investor in our company, I almost don't care what happens. Of course, I'm not numb about anything.

Our company can survive. We know how to move our assets on the world scene. So the institution will survive, but I am concerned in my other role as a citizen. What is happening—and I would hope to convey the sense of urgency—is that that component of our economy, industry, is so rapidly moving away from the United States because a large increment of it cannot operate its investments here as a function of two things—the dollar and certain other trade distortions.

In the course of your tenure as Senators, assuming each of you or others of the committee were to assume one more term of office, there may be a natural correction of the value of the dollar and there may be some relaxation of the trade distortion. You then will say to us, now please go out and export.

This country will not then have that determinative increment of an ability to be responsive and we will then be suffering a very fundamental weakness. And without that ability, I think we will have left a heritage or at least a very large window of difficult time for our country. Those then in positions of trying to do something worthy for their country will say, "How can we do it—export—we've been left denuded."

I said that I wished to emphasize a spirit of urgency. There are all manner of good commonsense observations that if we just let things move by themselves in the natural course of events, the dollar will correct itself, we will finally get the trade distortions sorted out. But my point is: the horse will have left the barn.

As a consequence of my concern for the country, my concern of a sense of urgency, we have been looking for any, even radical solutions to the problem. It's the surgery versus just hoping the patient gets well naturally in time. I respectfully suggest that some surgical solution is required.

We have even suggested something to and including the surcharge. We think it unto itself has balance. We think it has merit. We know it has difficulties. We think it could be useful temporarily to do something to move us in the direction of correcting the dollar, add income to correct the deficit. We believe that it would unto itself be useful in that regard as a temporary measure.

For the long term, we really think you should also be thinking of more permanent solutions such as: A value-added tax, and that could be a surrogate for other approaches to the problem.

Incidentally, if it is not otherwise sufficiently clear, my written testimony—nothing that we have in mind here is recommended as targeting on any one single country. We think this is generic. We think the rest of the world has some of the same problems that we have in those places where there are trade distortions.

But we are interested in some form of a serious and dedicated and almost immediate effort at changing the environment in which industry operates in the interest of the country.

Thank you, sir.

[The prepared statement of Mr. Galvin follows:]

MOTOROLA INC.

BEFORE THE
U.S. SENATE COMMITTEE ON FINANCE

HEARINGS ON FLOATING EXCHANGE RATES' IMPACT ON INTERNATIONAL TRADING

STATEMENT OF
ROBERT W. GALVIN
CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
MOTOROLA, INC.

April 24, 1985

SUMMARY

Motorola is deeply concerned about the current environment for doing business in the United States. The effects of the federal budget deficit, high interest rates, and overvalued dollar are all too clear in the current trade picture: an unprecedented trade deficit of $123 billion, affecting all sectors of the economy. In the electronics sector alone, our trade balance has declined from approximately a $7 billion positive balance in 1980 to a deficit of almost $7 billion in 1984, or a $14 billion decline.

The results of the systemic economic problems we are currently facing are a significant and, we believe, undesirable structural transformation in the U.S. economy. The strength of the U.S. currency causes U.S.-made goods to be overpriced in relation to foreign-produced goods. Consequently, since 1980, exports are down 15 percent and imports are up 15 percent over what would normally be the case if the dollar were in line with our relative costs. In addition, jobs have been lost, GNP & industrial production are down, and the trade and budget deficits are greater. More manufacturing is being lost to offshore locations through shifting of production and outsourcing, thereby eroding our industrial base and our ability to export, as well as undermining our technological lead.

In addition to the strong dollar, U.S. manufacturers continue to be hampered by lack of access to foreign markets and the continued unwillingness of our negotiators to deal forcefully with the wide variety of largely non-tariff, unfair trade barriers imposed by our trading partners. Most notable, of course, is the lack of access to the Japanese market where there is evidence to suggest that blaming the strong dollar as the primary cause of our lopsided trade balance is subject to serious question. I would urge the Congress to be unrelenting in its insistence on equal access to the Japanese and other world markets for U.S. high technology, state-of-the-art products.

This Committee is seeking proposed solutions to the problems created by the overvalued dollar. With the trade deficit worsening and concern growing that the Administration and the Congress would face substantial difficulties in making significant federal budget cuts or raising taxes, Motorola, following this Committee's lead, studied a temporary surcharge as an option should efforts to make needed spending cuts fall short. We developed an illustrative package consisting of a temporary (three-year, declining) surcharge coupled with other budget deficit reduction measures.

Such a package could result in a substantial and immediate reduction in the federal budget deficit -- nearly $100 billion in 1986 -- which will permit a looser monetary policy and hence lower interest rates and a devaluation of the dollar (Those who advocate that a temporary surcharge will cause the dollar to appreciate have also been telling us for the last 3-4 years that our large current account deficit should have caused the dollar to weaken). Further, it could be applied across the board and for a temporary period of time. Such an action could be taken consistent with our GATT obligations. Any negative impact on GNP or inflation would be influenced by the extent to which the foreign exporter will absorb the surcharge. Alternatively, a temporary surcharge could be an effective bridge to a longer term plan to revamp our taxing system through, for example, some form of consumption tax, such as a business transfer tax or a value added tax. The United States needs a tax that will encourage more savings and investment and even the playing field for goods that are traded internationally.

An immediate and substantial reduction of the federal budget deficit in order to bring interest rates and the value of the dollar down, thereby improving our trade deficit, must be coupled with meaningful responses to both the failure of the Japanese and others to open up their markets to highly competitive, state-of-the-art U.S. products as well as to the perpetuation of unfair trade practices in other world markets.

Mr. Chairman and members of the Finance Committee, I want to thank you for inviting me to appear before the Committee today to testify on the viability of our international trading system in light of the unprecedented U.S. current account and trade deficits. We heartily concur with Chairman Packwood's statement that the size of our current and projected U.S. trade and current account deficits is totally unacceptable. We commend the Committee for its dogged fight to focus attention on these critical problems now ingrained within our economic system and having a detrimental impact on the health and future viability of U.S. industry.

We further commend this Committee for seeking proposed solutions and leaving no stone unturned in its examination of a wide range of options. We urge that this Committee move expeditiously and decisively to translate your concerns into forceful and immediate action.

As a company involved in the worldwide manufacture and sale of high technology electronics and telecommunications products, Motorola has long attempted to play an active role in shaping the public debate over trade policy issues affecting its businesses and in proposing solutions. Motorola is deeply concerned about the current environment for doing business in the United States. The effects of the federal budget deficit, high interest rates, and overvalued dollar are all too clear in the current trade picture: an unprecedented trade deficit of $123 billion, affecting all sectors of the economy. In the electronics sector alone, our trade balance has declined from approximately a $7 billion positive balance in 1980 to a deficit of almost $7 billion in 1984, or a $14 billion decline.

The results of the systemic economic problems we are currently facing are a significant and, we believe, undesirable structural transformation in the U.S. economy. The strength of the dollar causes U.S.-made goods to be overpriced in relation to foreign-produced goods, making international competition untenable for U.S. exporters. Similarly, foreign goods imported into the U.S. are cheaper than domestically produced goods. In short, the overvalued dollar is driving a massive wedge between domestic and foreign production costs. For example, according to Data Resources, Inc. (DRI), Japan's unit labor costs for manufacturing industries averaged just 60 percent of U.S. labor costs in 1984 compared with over 90 percent of U.S. costs only five years ago. German costs were 95 percent of the U.S. level in 1984 as compared with being nearly 60 percent above the U.S. level five years ago. Consequently, since 1980, exports are down 15 percent and imports are up 15 percent over what would normally be the case if the dollar were in line with our relative costs. Such changes are not easily reversed -- even if the dollar imbalance is corrected. Foreign companies are building distribution networks designed to give them a permanent foothold in the U.S. market. Further, this increased import volume permits our foreign competition to achieve new economies of scale that will significantly enhance their price advantage.

In addition, since 1980, approximately 2 million jobs have been lost, real GNP is down 4 percent (Commerce Department figures for the first quarter of 1985 registered a "surprisingly low" 1.3 percent annual growth rate as a deluge of imports continued unabated into the U.S. market), and industrial production is down 9 percent. The federal budget and trade deficits are about $60-70 billion more than otherwise would have been the case. Our labor force and much of our manufacturing capacity are utilized today at levels which history would equate with a recession. More manufacturing is being lost to offshore locations through shifting of production and outsourcing thereby eroding our industrial base and our ability to export, as well as undermining our technological lead. From Motorola's own experience, for example, facilities originally planned for Illinois, Texas, South Carolina, and Arizona will instead be shifted to such locations as Singapore, Taiwan, and Malaysia. These current shifts may only be the tip of the iceberg for the future. What will remain if this trend is not reversed soon are marketing, sales, distribution, and service activities for products manufactured elsewhere in the world.

In addition to the strong dollar, U.S. manufacturers continue to be hampered by lack of access to foreign markets and the continued unwillingness of our negotiators to deal forcefully with the wide variety of largely non-tariff, unfair trade barriers imposed by our trading partners. Most notable, of course, is the lack of access to the Japanese market. Our trade deficit with the Japanese has soared to unprecedented levels and represents nearly 1/3 of our total trade deficit. While the Japanese frequently cite the strong dollar as the primary cause of our bilateral trade problem, available data on Japanese trade and exchange rates appear to raise serious questions about the legitimacy of this argument. While the yen depreciated 20 percent against the dollar between 1979 and 1983, it appreciated from 6 to 55 percent against currencies of five other major trading nations (U.K., France, Germany, Canada, Korea). Yet, in all cases, the Japanese trade balance with these countries moved in Japan's favor, and in all but Korea, growth of Japanese exports was markedly higher than Japanese imports. This was despite the fact that growth in Japanese domestic demand generally was greater than in the other countries. Based on these data, it is difficult to see how the Japanese can argue that exchange rates are a significant fact in determining their trade patterns with the U.S. or anyone else.

Current negotiations with the Japanese aimed at opening up their telecommunications market have been the subject of intense publicity in recent weeks. These negotiations and the absence of any real progress, as measured by increased sales in the Japanese market, have led to a heretofore unprecedented level of frustration among U.S. policymakers and affected industries. The Members of this Committee, and in fact 92 Members of the Senate, have responded by passing a Resolution directing the President to respond forcefully to Japan's unfair trade practices, which I understand has now been embodied as legislation (S. 770). In addition, legislation designed to use access to the U.S. market for telecommunications as leverage for removal of trade barriers by Japan and other nations has just been introduced (S. 942). I would urge the Congress to be unrelenting in its insistence on equal access to the Japanese and other world markets for U.S. high technology, state-of-the-art products.

Given the difficulties that U.S. exporters are having globally today with the strong dollar and barriers to market entry abroad, it is ironic that the U.S. Treasury Department has suggested in its so-called tax simplification proposal that certain tax benefits which have helped mightily to keep U.S. industry competitive now be abandoned. I refer specifically to Treasury's recommendation to phase out Section 936 (possessions corporations) of the IRS Code. The Treasury proposal includes other suggestions to eliminate tax code provisions which were originally instituted as incentives for business and industry to be more competitive. The federal government wants U.S. companies to provide jobs and to pay taxes, but it now proposes to eliminate many of the tax provisions which have been helping to make this possible.

Let me return to the focus of this hearing; namely, the viability of the international trading system in an era of floating exchange rates. We have been operating under a system of floating exchange rates since 1971 when the "Group of 10" nations of the world agreed to both devalue the dollar and to provide greater flexbility on the exchange markets. Throughout most of the 70's, the system of floating exchange rates seemed to be working as evidence by the relatively balanced trade flows.

Since 1980 however, the dollar has risen steadily even as the current account deficit has plunged to record lows. By the first quarter of this year, it was nearly 59 percent above its summer 1980 levels. A comparison of the dollar's upward spiral with the trade deficit's plunge reveals almost a "mirror" image effect (Chart 1 attached hereto).

This Committee is seeking proposed solutions to the problems created by the overvalued dollar. One significant step which is essential to correcting the problem is to achieve a substantial reduction in our unprecedented and growing federal budget deficit, preferably through a balanced program of expenditure cuts and/or revenue raising measures. The Senate and the Administration are currently involved in the process of attempting to reach agreement on a reported $50 billion in cuts. These efforts are to be commended and encouraged. However, they fall far short of what is needed to correct the current misalignments. Additionally, the political realities may well make even $50 billion worth of budget cuts too painful. If, on top of that, the Administration continues its pledge not to raise taxes, then what? Are we once again going to sit back and do nothing as we mortgage our children's futures? Or is it time to examine other admittedly more risky and less conventional proposals so as to attempt to avoid a precipitous decline in the value of the dollar which would bring with it rising inflation, higher interest rates, widespread unemployment and a prolonged recession?

In March of last year, this Committee announced hearings on the U.S. trade deficit. In his opening statement at the hearing, then Chairman Dole indicated interest in invoking section 122 of the Trade Act of 1974 to justify the imposition of a temporary import surcharge. Administration officials who testified roundly rejected the surcharge option and espoused the belief that the trade deficit would "eventually correct itself." Of course, just the opposite has occurred. The trade deficit has worsened in 1984 and is projected to get even worse in 1985.

With the trade deficit worsening and concern growing that the Administration and the Congress would face substantial difficulties in making significant budget cuts, we at Motorola felt it essential to begin studying a temporary surcharge as an option. We enlisted the assistance of econometricians. We developed an illustrative package consisting of a temporary surcharge coupled with other budget deficit reduction measures. The theory was that we needed a twin-edged sword: 1) an immediate and substantial reduction in the federal budget deficit and 2) a permanent solution to our current systemic economic problems that would have a longer term impact. Alternatively, a temporary surcharge could be an effective bridge to a longer term plan to revamp our taxing system. In this regard, the time has come for the United States to consider some form of consumption tax, such as a business transfer tax or a value added tax. The United States needs a tax that will encourage more saving and investment and even the playing field for goods that are traded internationally.

Briefly summarized, this illustrative package would consist of an across-the-board surcharge of 20 percent in 1986, 15 percent in 1987, and 7 percent in 1988 in combination with domestic deficit reduction measures amounting to $40 billion in 1986, $53 billion in 1987, and $86 billion in 1988 (see Attachment 1).

Such a package could result in a substantial and immediate reduction in the federal budget deficit -- nearly $100 billion in 1986 -- which will permit a looser monetary policy and hence lower interest rates and a devaluation of the dollar (Those who advocate that a temporary surcharge will cause the dollar to appreciate have also been telling us for the last 3-4 years that our large current account deficit should have caused the dollar to weaken). As U.S. interest rates decline, this will reduce the debt burden to LDC's and will keep more capital abroad to generate growth of other economies. Further, it could be applied across the board and for a temporary period of time, thereby reducing pressure for numerous sectoral import restrictions of a more permanent nature. Finally, it would contribute to greater long-term financial stability by reducing the risk of a sudden and precipitous drop in the dollar.

It is by no means a perfect solution. As with any domestic tax increase, there could be slower growth in the near term and a rise in inflation the first year. However, the impact on growth and inflation will be influenced by the extent to which the foreign exporter will simply absorb the surcharge. Based on estimates showing anywhere from a 30 to 57 percent gap between the advantage enjoyed by foreign exporters as a result of the dollar appreciation and importers' prices to the U.S. market over the past several years, it is a fair assumption that the foreign exporter might absorb at least half -- if not more -- of a 20 percent surcharge. This would, in turn, diminish any negative impact on growth and inflation.

Would our trading partners retaliate? There has been much discussion and speculation on this point. It is to be expected that our trading partners would threaten to retaliate. However, virtually every major trading partner currently enjoys a substantial trade surplus with the U.S. Hence, our trading partners have far more to lose in a tit-for-tat scenario. Secondly, the President could be given authority to deal with particularly hard-pressed debtor nations. Such an action could be taken consistent with our GATT obligations (see Attachment 2). Of course, several of our trading partners, including the United Kingdom, France, Canada, and Denmark have previously done so in order to rectify balance of payments problems.

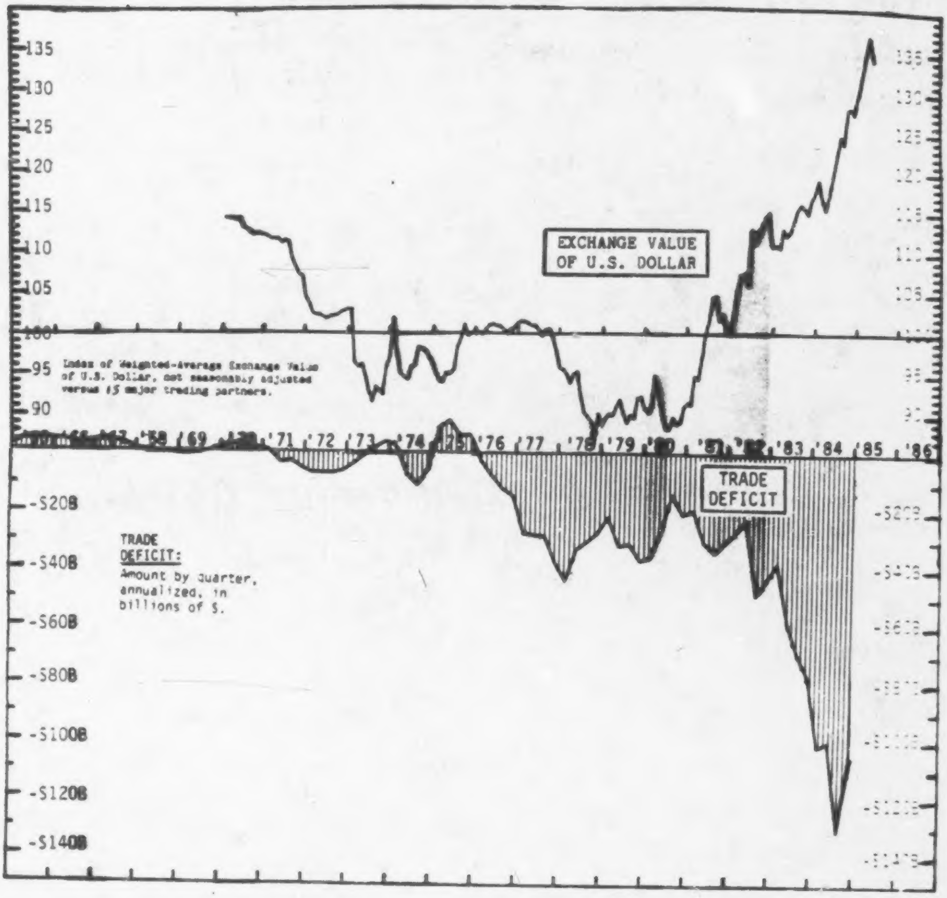
A surcharge viewed as a retaliatory measure solely against the Japanese has some clear political appeal -- particularly in the current climate. However, would it be the most effective means of achieving the goal of an open Japanese market and a reduced trade deficit with Japan? If the purpose of a surcharge aimed solely at the Japanese is to inhibit U.S. market access, it is unclear what level a surcharge would have to be imposed to be effective. In other words, the Japanese exporter may well be willing and able to rest on past unprecedented profit margins in order to ride out the imposition of a surcharge without losing market share in the lucrative and expansive U.S. market.

From Motorola's perspective, the twin focuses of the trade policy debate for 1985 must necessarily couple an immediate and substantial reduction of the federal budget deficit in order to bring interest rates and the value of the dollar down with meaningful responses to both the failure of the Japanese to open up its markets to highly competitive, state-of-the-art U.S. products as well as to the perpetuation of unfair trade practices in other world markets. Rhetoric and limited actions are no longer credible. The huge U.S. federal budget and trade deficits, high interest rates and the strong dollar represent a grave threat to the future of the U.S. economy and our national security. At the same time, the market access issue, particularly vis-a-vis Japan, also requires unprecendented and far-reaching action.

The failure by policymakers to recognize the magnitude and immediacy of the problem forces companies like Motorola to adjust their trade strategies and move their operations increasingly offshore. The Administration's economic policies have been highly successful in restoring economic growth and keeping inflation under control. However, the time has come for a major shift in policy direction to correct the serious international imbalances that have been created. Dramatic and timely changes are needed to stem the outflow if we do not want to witness the continued dismantling of U.S. industrial and technological strength.

CHART 1

U.S. DOLLAR VS. TRADE DEFICIT



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ATTACHMENT 1

The Case for an Import Surcharge

Background

The unprecedented U.S. budget and trade deficits, which have serious effects on interest rates, exchange rates, U.S. competitiveness, and industrial employment, can only be eased by a combination of innovative policy measures. It appears unlikely that the President and Congress will be able to agree on budget reductions or revenue enhancements of adequate magnitude to lead to needed improvements in the deficits, interest rates, and the value of the dollar. Meanwhile, our industrial base is eroding and the basic competitiveness of U.S. industry is in serious question.

Proposal for Temporary Import Surcharge

One possible action that should be given serious consideration is legislation that would provide for the imposition of a temporary surcharge on imports to be phased out over a three-year period, starting at 20 percent the first year, 15 percent the second year and 7 percent the third year. New legislative authority would be required because existing authority under Section 122 of the Trade Act of 1974 permits a surcharge of no more than 15 percent for a duration of up to 150 days.

It is recommended that, in conjunction with the temporary surcharge, budget deficit reduction measures also be implemented in order to maintain a constant level of reduction over the three-year period and to continue to provide improvement following its expiration. In addition, it is suggested that any such legislative proposal include authority for the President to alleviate any resultant LDC problems.

It is assumed that foreign exporters would absorb at least half the cost of the surcharge, since foreign exporters' U.S. prices have fallen only 10 percent during a period when the exchange rate value of the dollar has gone up 30 percent. Foreign exporters are riding on a comfortable cushion of profit. It is unlikely that they would readily sacrifice market share to maintain profit margins that are, in effect, windfalls of the exchange rate misalignments.

A review of the U.S.'s existing international obligations concludes that such a proposal may be imposed consistently with the GATT where "necessary and appropriate" to remedy balance of payments problems. It is believed that the current crisis being faced by the U.S. is so novel and so threatening that the necessary and appropriate standard has been met.

Benefits to the U.S.

It is believed that imposition of an import surcharge will have substantial and immediate results. A simulation of the effects of this proposal on an economic model yield the following results: a substantial and immediate reduction of the budget deficit ($85-100 billion annually for three years); an immediate improvement in the trade deficit; a positive long-term impact on U.S. interest rates and foreign exchange rates; a limited and temporary inflationary impact which is made up for as the surcharge is phased out; and greater long-run financial stability. In addition, there is less risk of an abrupt exchange rate shift.

Benefits to Our Trading Partners

Although there will undoubtedly be much discussion concerning potential retaliation by our trading partners if the United States were to implement legislation providing for a temporary import surcharge, there are in reality long-term benefits for our trading partners that cannot be underestimated.

The effects of an import surcharge would provide more predictability to our financial markets; reduce pressure on our trading partners' interest rates and enhance their ability to finance domestic growth; reduce pressure for trade protection; and reduce the interest burden on high-debt countries as U.S. interest rates decline. Again, inclusion of Presidential authority to deal with LDC's, high debt countries or other such problems is suggested.

Conclusion

This type of action is not without precedent. The U.S. imposed an import surcharge in 1971. Similarly, several of our trading partners have taken this action -- notably France, Canada, Denmark, and the United Kingdom. It is believed that the current crisis merits consideration of such an action again.

DRI Model: An Illustrative Package

Data Resources, Inc. (DRI) has run two simulations using its macro model of the U.S. economy in order to analyze the effects of this proposed program.

A simulation of the DRI model was constructed for the years 1985-91, assuming no changes from current policy, to serve as a base for analysis of the effects of the above described proposal. Under the DRI model, major components comprising the U.S. economic outlook without any change is as follows:

BASELINE OF THE U.S. ECONOMY

	1986	1987	1988	1989	1990	1991
(In billions of dollars)						
Exports	453.3	513.0	565.8	618.7	676.2	740.2
Imports[1]	539.1	600.5	653.2	713.1	781.2	847.8
Trade Balance	-85.8	-87.5	-87.4	-94.4	-105.0	-107.6
Exports (1972 $)	166.6	178.3	187.1	195.1	203.4	212.2
Imports (1972 $)	181.1	187.5	195.1	204.3	214.1	223.2
Trade Balance (1972 $)	-14.4	-9.3	-8.0	-9.2	-10.7	-11.1
Current Account Balance	-115.9	-120.5	-123.6	-133.8	-147.7	-153.8
Federal Government Deficit	-232.1	-258.0	-278.5	-315.8	-351.8	-389.1
GNP	4205.4	4583.2	4984.5	5397.0	5835.3	6298.0
GNP (1972 $)	1729.2	1790.0	1847.2	1899.1	1948.6	1994.2
(Percents)						
Prime Rate	14.5	14.2	14.1	14.0	14.0	13.9
Exchange Rate[2]	1.002	0.990	1.007	1.019	1.030	1.056
Consumer Price Index	3.4	3.6	3.8	4.0	4.2	4.4
Inflation Outlook[3]	4.8	5.4	5.4	5.4	5.5	5.6
Unemployment Rate	7.8	7.6	7.2	7.1	7.2	7.2

[1] Nominal imports of goods only are $400 billion for 1986, $447 billion for 1987 and $487 billion for 1988

[2] Trade Weighted, (1970 = 1)

[3] % Annual Change Consumer Price Index

Data Resources, Inc.

In the DRI "no policy change" baseline, the deficit remains close to 6% of the gross national product. The government's heavy appetite for funds combined with cautious monetary policy keeps interest rates high. The prime rate, for example, remains near 14% with inflation averaging 5.3%.

Since it is impossible to predict the timing of cyclical fluctuations more than a year or so in advance, DRI assumed none in 1986 and beyond. The baseline is thus best described as the mean of all possible paths that the economy could actually follow in the absence of policy change. Real gross national product growth averages a relatively modest 2.8% between 1984 and 1991. The unemployment rate remains above 7% throughout, and inflation returns from its present very low readings to 5% - 5.5%.

It is assumed that the Federal Reserve maintains its conservative stance throughout, holding the rate of growth of the narrowly defined money supply (MNY1) to 5% per year.

The above described proposal for a temporary surcharge coupled with other deficit reducing measures was then added to the baseline projection.

An Illustrative Package
(DRI Model)
Effect on the Deficit
(Static)

	%	Surcharge	Other Budget Deficit Reductions	Total
		(in billions of dollars)		
1986	20	80	40	120
1987	15	67	53	120
1988	7	34	86	120
1989	-	-	120	120
1990	-	-	133	133
1991	-	-	141	141

- Achieves roughly 50% budget deficit reduction in first year
- Buys time to institute budget deficit reductions of sufficient magnitude

The performance of the U.S. economy, with the combined temporary surcharge and other deficit reduction measures added to the baseline DRI model, would then look like this:

IMPACT OF SURCHARGE PACKAGE

	1986	1987	1988	1989	1990	1991
(In billons of dollars)						
Exports	458.4	509.8	550.2	602.7	672.4	754.7
Imports	490.0	532.6	595.4	688.3	771.5	853.2
Trade Balance	-31.5	-22.8	-45.3	-85.6	-99.1	-98.5
Exports (1972 $)	166.4	175.5	183.0	193.8	206.6	220.1
Imports (1972 $)	177.9	181.9	191.4	204.1	213.6	222.6
Trade Balance (1972 $)	-11.5	-6.4	-8.5	-10.3	-7.0	-2.4
Current Account	-61.6	-55.9	-81.4	-125.0	-141.8	-144.7
Federal Government Deficit	-133.4	-173.1	-192.1	-199.3	-176.3	-170.7
GNP	4261.6	4575.6	4896.9	5259.7	5723.4	6211.3
GNP (1972 $)	1718.3	1759.8	1807.1	1869.5	1942.2	2005.6
(Percents)						
Prime Rate	14.4	14.0	12.5	10.1	9.8	10.2
Exchange Rate[1]	1.017	1.027	1.020	1.001	0.973	0.967
Consumer Price Index	3.4	3.6	3.6	3.9	4.1	4.3
Inflation Outlook[2]	5.4	5.1	4.7	4.6	5.1	5.3
Unemployment Rate	8.0	8.2	8.1	7.8	7.4	7.1

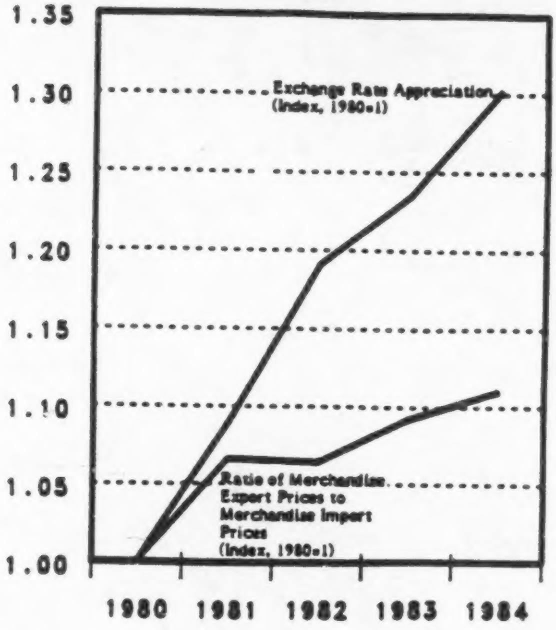
[1] Trade Weighted
[2] % Annual Change Consumer Price Index

Data Resources, Inc.

Two assumptions were made:

- that 1/2 of the tariff increase would be absorbed by the foreign exporters, i.e. they would cut their prices by 10% - a reasonable assumption since foreign exporters' U.S. prices have fallen only 10% during a period when the value of the dollar has increased 30%. Given this comfortable cushion of profit, it seems unlikely that foreign exporters would readily sacrifice market share to maintain profit margins that are, in effect, windfalls of the exchange rate distortions, particularly in light of the temporary nature of the tariff increase.

Exchange Rate Appreciation and the Ratio of Merchandise Export Prices to Merchandise Import Prices (Index, 1980=1)

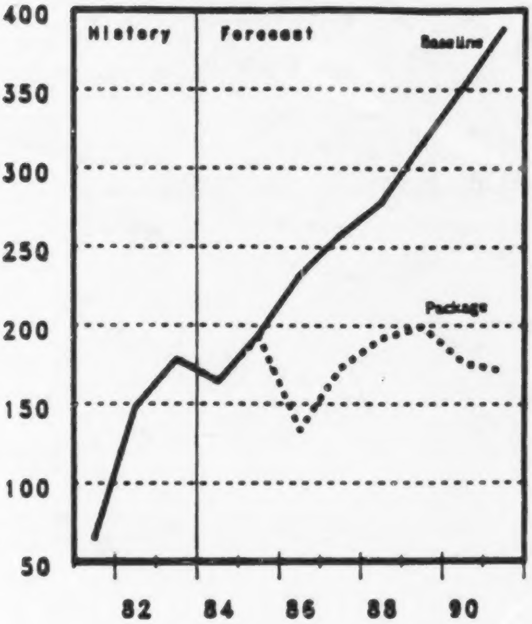


Data Resources, Inc.

- that there would be no foreign retaliation. (Benefits to our trading partners have previously been indicated. Presidential authority to deal with LDC problems or other concerns can also be provided to deal with any extraordinary hardships placed on our trading partners.)

The major effects of the proposed package are:

- A substantial and immediate reduction in the budget deficit ($85-100 billion annually for each of the three years and $210 billion by 1991).



Federal Government Deficit
(Billions of dollars)

Data Resources, Inc.

Do Nothing vs. Surcharge Package

(DRI Model)

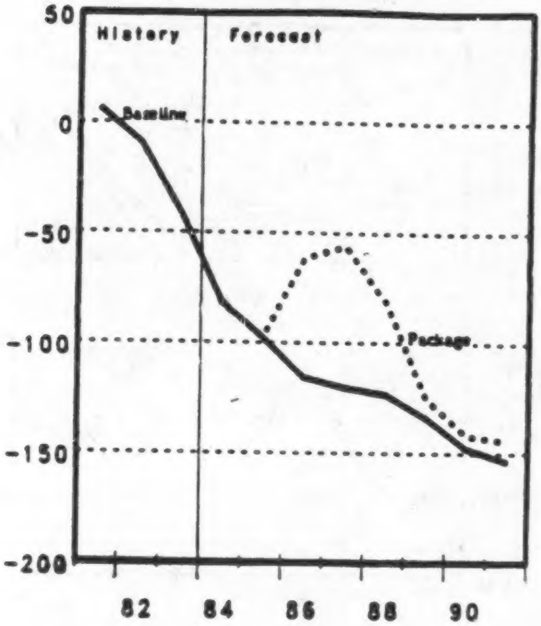
Effect on the Deficit

(Dynamic)

	Baseline (Do Nothing)	Package (with temporary Surcharge)
	(in billions of dollars)	
1986	232	133
1987	258	173
1988	279	192
1989	316	199
1990	352	176
1991	389	170

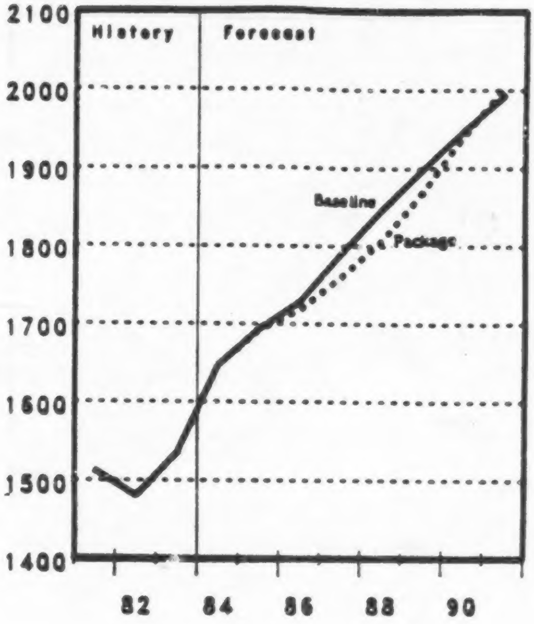
- An immediate improvement in the current account.

The U.S. Current Account Balance
(Billions of dollars)



GNP growth is slower in the near term but faster later.

Gross National Product
(Billions of 1972 dollars)



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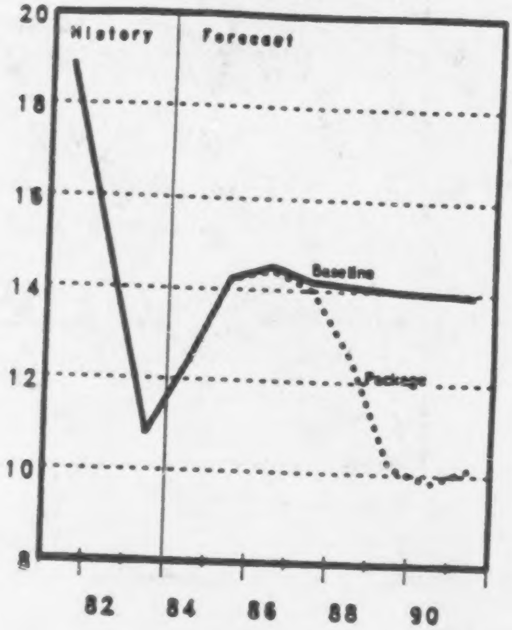
- A substantial reduction in the prime rate 2 years out to 12.5% and to 9.8% in 1990.

The Prime Rate
(Percent)



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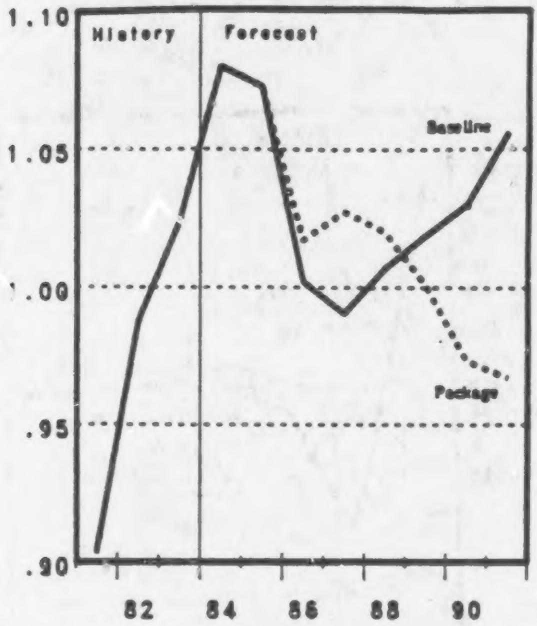
A gradual decline in the value of the dollar.

The Exchange Rate of the U.S. Dollar



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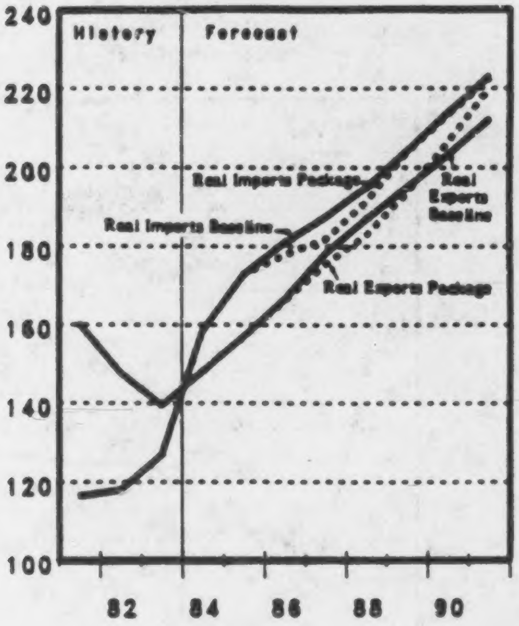
The fact that the simulation shows an initial appreciation of the dollar is subject to question since the recent behavior of the dollar has not followed historic patterns.

Since exchange rate fluctuations are difficult to predict, it is reasonable to review the results of the surcharge package without an immediate appreciation in the value of the dollar. Using this assumption, by 1991 the federal deficit is lower by $5 billion, the current account improves by $3 billion, GNP growth passes 4 percent, and exports increase more than 10 percent over baseline projections.

An immediate reduction in imports, little effect on exports, and an improved trade balance, both initially and over the long term.

Exports and Imports: Real
(Billions of 1972 dollars)



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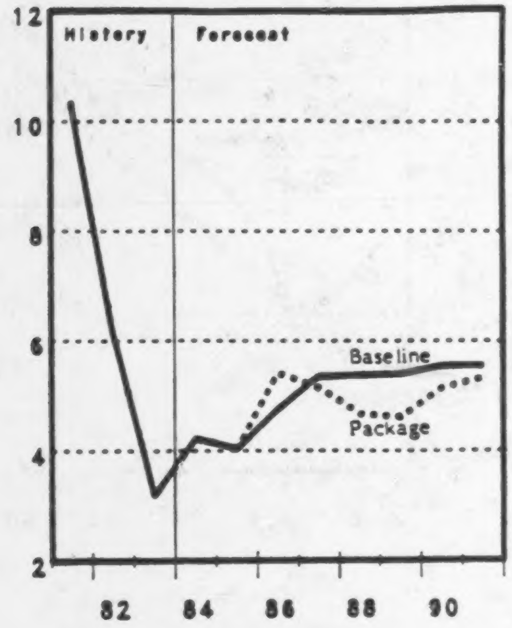
inflation improves after the initial impact of the surcharge.

Inflation Outlook: Consumer Price Index
(Annual rate of change)



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ATTACHMENT 2

MEMORANDUM

March 6, 1985

The Status of a Temporary Import Surcharge To Remedy the United States' Balance-of-Payments Crisis Under the General Agreement on Tariffs and Trade

In the face of a huge and growing trade and balance-of-payments current account deficit, and an unprecedented failure of exchange rate corrective processes, a declining and self-liquidating flat surcharge on the dutiable value of imports into the United States has been proposed. This proposal would provide for the imposition of a flat *ad valorem* surcharge of twenty (20) percent in 1986 that would decline to fifteen (15) percent in 1987, and seven (7) percent in 1988. This memorandum examines the proposed temporary surcharge in light of the obligations of the United States under the General Agreement on Tariffs and Trade (GATT) and concludes that (1) such an import surcharge may be imposed consistently with the GATT for the purpose of protecting a nation's balance of payments, and (2) the crisis faced by the United States is so novel and so threatening to the U.S. balance of payments and U.S. monetary reserves that the proposed surcharge is necessary, appropriate and consistent with the GATT.

Factual and Historical Background

Due significantly to the unprecedented strength of the American dollar, the United States is currently experiencing record deficits in both its balance-of-payments current account and its balance of trade. As demonstrated in Table I of attached Appendix A, the current account balance-of-payments deficit for the second quarter of 1984 reached a record annualized rate of 97.6 billion dollars, following a previous record of 78.8 billion dollars in the first quarter of the year and substantial and increasing deficits throughout the four quarters of 1983. Meanwhile, the third quarter U.S. merchandise trade deficit soared to a record annualized level of 133.2 billion dollars, eclipsing the previous highs of approximately 104 billion dollars in both of the first two quarters of the year.[1]

Theoretically, under a regime of floating exchange rates, this massive imbalance should long ago have been corrected by the reduction of the value of the dollar caused by the supply of dollars flooding the market in payment for these imports. However, this correction mechanism has not worked in this case due to the equally massive capital flows fleeing slower foreign economies and seeking the safety and return of investments in the growing U.S. economy. These capital flows, primarily into relatively liquid, short-term investments,[2] have created a dangerously unstable balance-of-payments situation in the United States[3] which, if the flows were reversed, could destroy U.S. international monetary reserves.

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[1] United States Department of Commerce, Office of Trade and Industry Information, Current International Trade Position of the United States (August 1984); Department of Commerce News, Bureau of Economic Analysis, September 17, 1984; Washington Post, November 9, 1984, page B1.

In part to counter these huge trade and payments deficits, a twenty percent ad valorem surcharge on imports in 1986 has been proposed. The surcharge under consideration would be reduced to fifteen percent in 1987 and seven percent in 1988 and would be eliminated in 1989. It has also been proposed that the surcharge be coupled with Presidential discretion, for example, to extend enhanced General System of

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[2] See "A Nation Hooked on Foreign Funds," New York Times, November 18, 1984, Section 3, page 1 (hereinafter cited as "Hooked Nation"). "Global Bank Meeting Cites Progress," New York Times, September 25, 1984, Section D, page 1 (quoting Bundesbank Chairman Karl Otto Pohl). Foreign assets in the United States, which totalled 784.5 billion dollars at the end of 1983 have increased to 833.1 billion dollars at the end of the second quarter of 1984. The composition of the investment has remained relatively stable. Major components include: 21 percent in treasury securities; 5 percent in corporate and agency bonds; 12 percent in stocks; 17 percent in direct investment; and approximately 40 percent in other bank liabilities. Sources: Department of Commerce, Survey of Current Business, The International Investment Position of the United States in 1983; Department of Commerce, Survey of Current Business, U.S. International Transactions, Second Quarter 1984, Table 1-2 at 39 (September 1984).

[3] See "Hooked Nation," supra note 2 (quoting economist Martin Feldstein); "Economic Scene; The Dangers if the Dollar Falls," New York Times, September 19, 1984, Section D, page 2 (quoting Professor Lester Lave of Carnegie - Mellon University describing the current capital crisis as a "Ponzi game").

Preferences (GSP) benefits to developing countries for the duration of the surcharge and to exempt countries experiencing severe financial problems that threaten immediate disruption of the international financial system.

The United States has imposed an import surcharge once before. In 1971, as part of a complex international and domestic program that imposed a ninety-day wage and price freeze, reduced taxes, federal spending and foreign aid, and suspended the full convertibility of U.S. dollars into gold, President Nixon imposed a ten percent surcharge on imports into the United States.[4]

Compared to the present situation, the deficits in 1971 were mild. The 1971 U.S. surcharge was triggered by balance-of-payments current account deficits that had worsened to 3.8 billion dollars in 1971 following a decade of moderate deficits.[5] The United States also had experienced its first trade deficit since 1893 (3.2 billion dollars in 1971-II).

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[4] See United States v. Yoshida International, Inc., 526 F.2d 560, 567 n.4, (C.C.P.A. 1975) (upholding the surcharge under domestic law); GATT Doc. C/M/71 (September 2, 1971) (minutes of GATT Council meeting concerning the United States temporary import surcharge). The surcharge exempted goods subject to quotas, duty free goods and goods in transit as of the date of the surcharge. GATT Doc. C/M/71.

[5] As more fully detailed in Table III of Appendix A, the U.S. current account sufferred deficits of 1.3, 1.9, .2, and 3.8 billion dollars in 1968-71 following surpluses of between 1.3 and 5.8 billion dollars from 1960-68. However, significant deficits occurred throughout the period in the combined current and long term capital account. U.S. Department of Commerce, Business Statistics (1975) at 17.

Although the United States withdrew the surcharge after less than five months, Yoshida, 526 F.2d at 568, the surcharge stimulated a multinational currency agreement among the major developed countries that realigned the then fixed exchange rates and "gave promise of ending the overvaluation of the U.S. dollar." Id. at 568-69.

Discussion

The GATT, which is the principal document governing world trade, provides both a framework for the negotiation of international trade and tariff agreements and specific strictures governing trading relations among the signatory nations (the "contracting parties"). Originally intended to lower the barriers to efficient trade, the GATT outlaws most quantitative trade restrictions (i.e., quotas) and provides for the negotiation of broadly applicable tariff concessions. These tariff concessions are identified in a complex of tariff schedules, to which the contracting parties must adhere.

GATT has no formal enforcement body. The only remedy available to signatory nations that believe they are being harmed by a GATT violation is trade retaliation.[6] Article

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[6] Although domestic judicial enforcement of the treaty may be attempted, it is unlikely to succeed. In the case of the 1971 United States surcharge, a foreign manufacturer had claimed the surcharge violated GATT. The court paid little attention to the argument, noting only that the surcharge appeared to be an accepted practice and that Congress had never ratified GATT. See United States v. Yoshida Interna-

(footnote continued)

XXIII of the Agreement provides for consultation if a contracting party believes it is being harmed by a violation of the GATT. If a violation is deemed to be occurring, the Article provides that the affected party may "suspend the application to any other contracting party or parties of such concessions or other obligations under this Agreement as they determine to be appropriate." Article XXIII:2; See Article XII:4 (authorizing trade retaliation in the case of unauthorized balance-of-payments measures discussed below).

Among the specific requirements of the GATT are several articles governing tariffs levied by the contracting parties. GATT Article II:1(b) provides that tariffs on imports from a contracting party shall be limited to the duties established on GATT tariff schedules and shall "be exempt from all other duties or charges in excess of those imposed on the date of this Agreement or those directly and manditorily required to be imposed thereafter by legislation in force in the importing territory on that date."

While this provision would appear to prohibit the proposed surcharge, Article XII of GATT grants a contracting

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tional, Inc., 526 F.2d 560, 575 n.22 (C.C.P.A. 1975). While this reasoning may not be conclusive, it reflects the well established judicial reluctance to sit in judgment of the compliance of the United States with obligations owed directly to foreign governments. See, e.g., George E. Warren Corp. v. United States, 94 F.2d 597, 599 (2d Cir. 1938); Z. & F. Asset Realization Corp. v. Hull, 114 F.2d 464, 471 (D.C. Cir. 1940), aff'd on other grounds, 311 U.S. 470 (1941).

party the right to impose certain trade restraints "in order to safeguard its external financial position and its balance of payments." Thus, Acticle XII permits restriction of the quantity or value of imported merchandise to the extent necessary:

> (i) to forestall the imminent threat of, or to stop, a serious decline in [a contracting party's] monetary reserves; or
>
> (ii) in the case of a contracting party with very low monetary reserves, to achieve a reasonable rate of increase in its reserves.[7]

Article XII provides a basis for the proposed surcharge.

A. The GATT Legality of Balance-of-Payment Tariffs

Despite the fact that the Article XII exception, which explicitly permits restrictions on the "quantity or value of merchandise permitted to be imported," does not literally encompass tariff restraints,[8] policy, custom, and recent international agreements make clear that balance-of-payments surcharges have become an accepted part of international law and the law of GATT.

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[7] The full text of Article XII is attached as Appendix B, hereto.

[8] See, e.g., J.Jackson, World Trade and the Law of GATT 711 (1969); see Comment, Attacks on the United States Import Surcharge Under Domestic and International Law: A Pragmatic Analysis, 6 J. of Int'l L. & Econ. 269, 276 (1972), Roessler, The Gatt Declaration on Trade Measures Taken for Balance-of-Payment Purposes: A Commentary, 12 Case W. Res. J. Int'l L. 383, 388-89 (1980). GATT consultation groups considering prior balance-of-payments surcharges have usually noted this fact. See, e.g., GATT Doc. L/3573 (September 13, 1971), at 11 (United States 1971); GATT Doc. L/3648 (December 23, 1971), at 10 (Denmark 1971); GATT Doc. C/50 (December 14, 1964) (United Kingdom 1964).

The principal approach of the GATT to trade restrictions, implemented through the Article XI prohibition on non-tariff trade barriers,[9] was that tariffs were acceptable trade practices while quotas were unacceptably rigid and generally improper. Thus, countries (including the United States in 1971) imposing balance-of-payments restraints have frequently selected tariff surcharges rather than quantitative restraints[10] arguing that whatever the language of Article XII, tariffs, being less restrictive than quotas, should be permitted.[11] In these cases, where restrictions were found to be otherwise appropriate, a waiver was granted or the violation was ignored. Indeed, the GATT Committee on Balance-of-Payments Restrictions reported, with respect to a particular surcharge, that no waiver was required but "that all the conditions and criteria embodied in the appropriate provisions of the General Agreement concerning the use of quantitative restrictions for balance-of-payments reasons should be deemed applicable in respect of this import charge."[12] Thus, it may be argued that balance-of-payments surcharges have become an accepted part of customary international law despite the literal provisions of Article XII.[13]

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[9] Article XI:1 provides that

> [n]o prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licenses or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation or sale for export of any product destined for the territory of any other contracting party.

[10] Several nations have imposed balance of payments surcharges since 1955, including France (1955), Canada (1963), the United Kingdom (1964), and the United States and Denmark (1971). See Jackson, supra note 8, at 712 n.5; GATT Doc. C/M/71, supra note 4; GATT Doc. L/3648, supra note 8.

[11] Thus, the United Kingdom, justifying its 1964 balance-of-payments surcharge, stated:

> The United Kingdom authorities are aware that Article XII assumes that any necessary restraint on imports will be imposed by means of quantitative restrictions. However reduction in the country's balance-of-payments deficit required urgent action which could only have been delayed while the elaborate administrative machinery of import licensing was re-established and licenses were

(footnote continued)

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> allocated to importers. During such a period the flow of trade might well have been unnecessarily disrupted. It has been the conclusion of the United Kingdom authorities that insofar as such charges avoid the dangers of freezing the existing pattern of trade and allow it to find its own level according to the need of importers and to consumers' preferences, and insofar as traders both at home and overseas would be free to make their own arrangements such import charges are to be preferred.

Jackson, supra note 8, at 713 (quoting GATT Doc. L/2285, at 1 (1964)).

[12] Roessler, supra note 8, at 388 (quoting GATT Doc. L/4200, at 12 (1975)).

[13] As Professor Jackson noted in 1969 "surcharges have become almost a de facto part of the General Agreement." Jackson, supra note 8, at 714; accord, S. Rep. 93-1298, 1974 U.S.C.C.A.N. 7236 (November 26, 1974) (on the Trade Act of 1974, which enacted into domestic law presidential authority to impose a balance-of-payments surcharge) ("the use of surcharges for balance-of-payment purposes has gained de facto acceptance" in GATT); Roessler, supra note 8 at 388 (the preference for quantitative restrictions has gradually become ignored).

Moreover, the 1979 Tokyo Round GATT Agreement Relating to the Framework for the Conduct of International Trade (the Tokyo Round Framework Agreement), while not a formal amendment to the GATT, implies that tariffs are, in fact, preferred to quotas in Article XII cases. The Declaration on Trade Measures Taken for Balance-of-Payments Purposes (the "Tokyo Round Declaration")[14] provides that "in applying restrictive import measures contracting parties shall abide by the disciplines provided for in the GATT and give preference to the measure which has the least disruptive effect on trade." The preamble to the Declaration notes that "restrictive import measures other than quantitative restrictions have been used for balance-of-payments purposes." Thus, the favorable reference to the "least disruptive" measure was clearly intended to be a veiled reference to tariffs.[15]

In sum, balance-of-payments surcharges that comply with the requirements of Article XII are acceptable under the GATT and are unlikely to provoke retaliation from other contracting parties.

B. The Proposed Surcharge Complies with the Requirements of Article XII.

Article XII permits the use of balance-of-payments trade restraints by a country to "safeguard its external financial position and its balance of payments." There can be little doubt that extraordinary action is necessary to safeguard the financial position and the balance of payments of the United States from the effects of the unprecedented instability that now exists.

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[14] The full text of the Declaration is attached as Appendix C, hereto.

[15] *See* Roessler, *supra* note 8, at 389-91.

Despite persistent current account deficits of a magnitude unheard of in the history of international trade, the dollar has failed to weaken. A crisis of confidence in the relatively weak economies of U.S. trading partners has resulted in a massive demand for capital investment in the United States that has kept the dollar at a severely inflated value. Yet this inflow is in large part liquid capital, that could be withdrawn at any time, resulting in catastrophe for the U.S. and world economies. Thus, the United States is faced with an untenable current balance of payments and an unprecedented, precarious financial position.

Nor does the stated limitation of Article XII:2(a), that the surcharge not exceed action necessary "to forestall the imminent threat of . . . a serious decline in [the United States'] monetary reserves; or . . . to achieve a reasonable rate of increase in its reserves," impair the GATT legality of the proposed surcharge. First, the literal focus of the limitation on monetary reserves is of limited value in a world economy characterized by floating exchange rates; and the proposed surcharge clearly falls within the intended scope of the limitation. Second, even if the limitation is interpreted literally and monetary reserves are examined, the proposed surcharge falls within its language.

The GATT was drafted and adopted during the era of fixed exchange rates, when currency exchange values were established and maintained by government actions. The structure of the existing international monetary system was an essential element in the creation of the GATT structure.[16] Monetary reserves, in turn, were of balance-of-payments significance in the fixed exchange rate regime for use by a government's monetary authority to intervene in world financial markets to protect the fixed value of its currency. The significance of monetary reserves are dramatically reduced under a floating exchange regime since such intervention makes little sense where there is no fixed value to protect.

In this context, it seems reasonable that, if it is to have any remaining validity at all,[17] Article XII:2(a) should not be confined narrowly to its literal provisions but should be interpreted to carry out its original intent and purpose.[18] Article XII was directed at a specific problem -- the inability of a nation to sustain a deteriorating trade balance without the risk of significant disruption to its domestic economy. Symptomatic of the risk of significant disruption under fixed exchange rates was the deterioration of monetary reserves. Absent those reserves, more dramatic and disruptive measures than intervention, such as devaluation, were all that remained to alleviate the trade imbalance. But under floating exchange rates there are other, more significant symptoms of the risk that a severe trade imbalance will disrupt an economy. Most significant among these are the source and nature of the capital flows maintaining high currency values in the face of severe trade deficits.

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[16] Indeed, the GATT explicitly recognizes the importance of the fixed exchange rate in the calculation of GATT tariff concessions. See, e.g., Article II:(b) (requiring GATT duty schedules to be "expressed in the appropriate currency at the par value accepted or provisionally recognized by [the IMF].") (emphasis added); Article II(3) ("No contracting party shall alter its method of . . . converting currencies so as to impair the value of any of the concessions provided for in the appropriate Schedule annexed to this Agreement.").

[17] It may be argued with some force that Article XII:2(a) should be read out of Article XII and that balance-of-payments actions should be limited to cases where needed by a country to "safeguard its external financial condition and its balance of payments" as required by Article XII:1.

The capital flows "financing" the U.S. trade imbalance are, in significant part, highly liquid and inherently volatile. They depend on a variety of perceptions and psychological factors that could be reversed at any time. Were such a reversal to occur, severe disruption of the U.S. and world economies would likely follow. In short, the risk of disruption to the U.S. economy is sufficiently great to permit Article XII action.

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[18] See Article 31 of the Vienna Convention on the Law of Treaties; Restatement (Revised) of the Foreign Relations Law of the United States § 329(1) (tent. draft No. 1) (April 1, 1980) ("An international agreement shall be interpreted in good faith in accordance with the ordinary meaning to be given the terms of the agreement in their context and in the light of its object and purpose.") (emphasis added).

But even if the literal terms of Article XII:2(a) are still deemed to apply and U.S. reserves are examined, the proposed surcharge would not exceed action necessary "to forestall the imminent threat of . . . a serious decline in [the United States'] monetary reserves; or . . . to achieve a reasonable rate of increase in its reserves." To be sure, the flood of foreign capital in 1983 and 1984 has kept official United States reserve holdings of gold and foreign currencies relatively stable at approximately 34.5 billion dollars.[19] However, any reversal or diminution of current capital flows, coupled with the massive current account deficit of close to 100 billion dollars, could literally wipe out these reserves. In light of the extremely volatile nature of the short term liquid capital flows that constitute a significant portion of the capital flooding the United States, the situation must be considered to create an imminent threat to United States monetary reserves.

Moreover, Article XII:2(a)(ii) permits balance-of-payments restraints "in the case of a contracting party with very low monetary reserves." United States monetary reserves have remained reasonably constant in the face of the current balance-of-payments crisis, at a level that, in absolute terms, might appear high by world standards. However, by their nature, reserves must be evaluated in light of the dynamic accounts against which the reserves are held. Viewed against a current account deficit that is expected to exceed 100 billion dollars in 1984[20] and against total short term capital holdings by foreigners that are many times that,[21] the United States reserve of 34.5 billion dollars is very low indeed.

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[19] Department of Commerce, Survey of Current Business, U.S. International Transactions, Second Quarter 1984, n.4 to Table 1-2 at 55 (September 1984). By comparison, in 1971, U.S. reserve assets had fallen approximately seven billion dollars (to 10.4 billion dollars) from 1960 to 1971. GATT Doc. C/M/71, supra note 4; Department of Commerce, Survey of Current Business, U.S. International Transactions, First Quarter 1984, Table 1 at 42-43 (June 1984).

These claims -- that (1) reliance on volatile short term capital flows to finance massive deficits creates an imminent threat to monetary reserves and (2) that the determination that reserves are very low must be based on a relative analysis -- are not novel in Article XII situations. In 1971 Denmark essentially justified its Article XII import surcharge with these same arguments.

In 1971 Denmark was experiencing a current account deficit of approximately 350 million dollars with reserves of approximately 400 million dollars that had remained reasonably constant over time.[22] Much of the current account deficit was financed "with an abnormally large share of short-term liability," causing the Danish government to fear for its continued abilities to fund its balance-of-payments deficit in light of the uncertainties created in world markets by the 1971 United States surcharge.[23] Moreover, when challenged with the fact that Danish reserves had in fact not decreased for several years, the Danish representative responded "what might have been considered as adequate reserves in the past could not be regarded as such in the present international monetary situation."[24]

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[20] See "Hooked Nation," supra note 2.

[21] See note 2, supra. Since this total represents the supply of dollars that could quickly flood the world market, it provides a good standard against which to measure U.S. reserve holdings and the ability of the U.S. government to defend the dollar were the demand for U.S. capital investment to fall.

The International Monetary Fund (IMF), exercising its duty under GATT to determine whether the criteria of Article XII had been met,[25] concluded that Denmark had established that the import surcharge did not "go beyond the extent necessary to bring about the desired improvement in the balance of payments." GATT Doc. L/3648, supra note 8, at 2. The GATT Working Party consulting on the surcharge recognized that Denmark was in a serious balance-of-payments situation but was divided on the question of the appropriateness of the surcharge. Id. at 10.

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[22] See GATT Doc. L/3648, supra note 8, at 2-4; GATT Doc. C/M/74 at 8.

[23] GATT Doc. C/M/74 at 8.

[24] GATT Doc. L/3648, supra note 8, at 5.

[25] GATT Article XV:2 provides that:

> [t]he CONTRACTING PARTIES, in reaching their final decision in cases involving the criteria set forth in paragraph 2(a) of Article XII . . . , shall accept the determination of the Fund as to what constitutes a serious decline in the contracting party's monetary reserves, a very low level of its monetary reserves or a reasonable rate of increase in its monetary reserves, and as to the financial aspects of other matters covered in consultation in such cases.

It seems reasonably clear that if stable reserves of 400 million dollars can justify a balance-of-payments surcharge in the face of a current account deficit of 350 million dollars financed in significant part by short term debt, the present situation of the United States, where the current account deficit dwarfs reserves, must be within the ambit of Article XII.

Further, it would appear, based on the discussion of the Working Party on the 1964 United Kingdom balance-of-payments surcharge, that the ability to fund a balance-of-payments crisis through debt-financed reserve assets should not be considered in determining the effect of the crisis on reserves. The United Kingdom imposed its surcharge on the basis of an 800 million pound current/long-term capital account deficit despite the fact that it conceded, and the IMF found, that "resources were available to the United Kingdom to finance this deficit, including a $1 billion stand-by arrangement with the International Monetary Fund."[26]

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[26] GATT Doc. C/50, supra note 8, at 11.

Both the IMF and GATT agreed that the surcharge was appropriate.

In part, the IMF and GATT acceptance of the U.K. surcharge may have been motivated by a recognition that a nation should not be required to incur heavy debt to finance serious balance-of-payments difficulties. Such a rule would require a nation to, in effect, mortgage its future to support current consumption of foreign goods rather than permitting it to discipline domestic consumption by increasing the price of those goods. This would be particularly inappropriate where, as now, capital flows are preventing the adjustment mechanism of a floating exchange rate regime from operating, thereby forcing the troubled importer to engage in present consumption.

Nor should the argument that the United States balance-of-payments difficulties are attributable to capital flows caused by high interest rates fueled by the federal deficit affect the GATT legality of the propcsed surcharge. Although the Tokyo Round Declaration states that the contracting parties do not favor import restrictions as a method of curing a balance-of-payments problem since alternative remedies (most notably devaluation and domestic economic policies) are likely to exist that are less disruptive to other nations, see Roessler, supra note 8, at 389,[27] Article

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[27] The Preamble to the Tokyo Round Declaration recognizes (i) "that the impact of trade measures taken by developed countries on the economies of developing countries can be (footnote continued)

XII:3(d) of GATT explicitly provides that a contracting party may not be required to withdraw a balance-of-payments restriction on the ground that domestic policy alternatives are available to remedy a balance-of-payments problem.

Indeed, the proposed 20 percent surcharge is likely to be less disruptive to trade and to U.S. trading partners than such traditionally accepted mechanisms as devaluation or other policies leading to dollar depreciation. The surcharge will operate as a 20 percent depreciation of the dollar with respect to U.S. imports. A similar realignment of exchange rates would affect both U.S. imports and exports, imposing a much greater burden than the surcharge on U.S. trading partners.

Nor may it be said that the proposed surcharge will distort trade. Trade distortion is presently occurring due to the over-valuation of the dollar and the failure of the floating rate adjustment mechanism. The proposed surcharge merely seeks to remedy this distortion in the least disruptive manner.

(footnote continued from previous page)
serious" and (ii) "that developed contracting parties should avoid the imposition of restrictive trade measures for balance-of-payments purposes to the maximum extent possible." Further, the Preamble states that the contracting parties are "[c]onvinced that restrictive trade measures are in general an inefficient means to maintain or restore balance-of-payments equilibrium." Section 11(d) of the Declaration requires that balance-of-payment consultations include consideration of available domestic alternatives.

In sum, the United States is suffering from an extreme balance-of-payments problem. The instability of capital flows, and the sheer magnitude of the current account deficit indicates a significant reserve crises. Article XII action should be deemed justifiable.

C. The Proposed Surcharge Complies With All Additional GATT Restrictions That May Be Relevant

In addition to the foregoing, Article XII and the Tokyo Round Declaration impose numerous other conditions on balance-of-payments trade restrictions. All appear to be consistent with the proposed surcharge. However, in the interest of completeness and to facilitate development of a final proposal, those conditions that appear to be relevant will briefly be noted in this section.

Pursuant to Article XII, a balance-of-payments restriction must not create unnecessary damage to the commercial or economic interest of any other contracting party. Article XII:3(c)(i). It has been suggested that the President be authorized to exempt countries experiencing severe financial problems.

Restraints must be temporary in nature and must be progressively relaxed as conditions improve. Article XII:2(b). The Tokyo Round Declaration further provides that "wherever practicable, contracting parties shall publicly announce a time schedule for the removal of the measures."

The proposed surcharge would be imposed for a maximum period of three years.

The Tokyo Round Declaration provides that "the simultaneous application of more than one type of trade measure for [balance-of-payments purposes] should be avoided." The United States has not at this time imposed any trade measures for balance-of-payments purposes. Existing trade measures have been imposed either to remedy specific GATT violations (e.g. antidumping and countervailing duties) or to prevent disruption in specific industries. Thus, this provision should not raise objections to the proposed surcharge.

Finally, balance-of-payments restrictions must be nondiscriminatory, i.e., they must apply equally against all other contracting parties. Cf. Article XIII (requiring balance-of-payments quotas to be nondiscriminatory). However, the Tokyo Round Declaration explicitly recognizes the potential harm to developing countries of surcharges imposed by developed countries, and provides that developed countries "may exempt from its measures products of export interest" to developing countries. The proposal under consideration authorizes the President to extend enhanced GSP benefits to developing countries during the term of the surcharge.

D. Conclusion.

The proposed import surcharge complies with all requirements of the GATT and, in light of the unprecedented, volatile balance-of-payments crisis facing the United States, is reasonable and appropriate.

APPENDIX A

TABLE I

1983-84 Current Account Balance of Payments and Trade
(annualized rate - $ billions)

	1983 I	II	III	IV	1984 I	II	III
BOP Current Account	-12.0	-38.2	-47.4	-68.9	-78.8	-97.6	n/a
Merchandise Trade	-36.9	-59.5	-70.0	-77.6	-103.6	-102.8	-133.2

Sources: United States Department of Commerce, Office of Trade and Industry Information, Current International Trade Position of the United States (August 1984); Department of Commerce News, Bureau of Economic Analysis, September 17, 1984; Washington Post, November 9, 1984, page B1.

TABLE II

U.S. Official Reserve Assets: Net Change (increase +)
($ billions)

1965	-1.225	1976	2.558
1966	- .570	1977	.375
1967	- .053	1978	- .732
1968	.870	1979	1.133
1969	1.179	1980	8.155
1970	-2.481	1981	5.175
1971	-2.379	1982	4.965
1972	.004	1983	1.196
1973	.158	1984-I	.657
1974	1.467	1984-II	.566
1975	.849		

Sources: Department of Commerce, Survey of Current Business, U.S. International Transactions, First Quarter 1984, Table 1 at 42-43 (June 1984); Department of Commerce News, Bureau of Economic Analysis, September 17, 1984.

TABLE III

U.S. **Balance** of Payments Data Preceeding 1971 Surcharge.
($ billions)

	Current Account	Current & Long Term Capital
1960	1.774	-1.211
1961	3.048	- .020
1962	2.446	-1.043
1963	3.188	-1.339
1964	5.764	- .100
1965	4.299	-1.817
1966	1.635	-2.621
1967	1.273	-3.973
1968	-1.313	-2.287
1969	-1.956	-3.949
1970	- .281	-3.760
1971	-3.879	-10.637

Source: U.S. Department of Commerce, Business Statistics (1975) at 17.

APPENDIX B

ARTICLE XII OF GATT

Article XII

Restrictions to Safeguard the Balance of Payments

1. Notwithstanding the provisions of paragraph 1 of Article XI, any contracting party, in order to safeguard its external financial position and its balance of payments, may restrict the quantity or value of merchandise permitted to be imported, subject to the provisions of the following paragraphs of this Article.

2. (a) Import restrictions instituted, maintained or intensified by a contracting party under this Article shall not exceed those necessary:

(i) to forestall the imminent threat of, or to stop, a serious decline in its monetary reserves, or

(ii) in the case of a contracting party with very low monetary reserves, to achieve a reasonable rate of increase in its reserves.

Due regard shall be paid in either case to any special factors which may be affecting the reserves of such contracting party or its need for reserves, including, where special external credits or other resources are available to it, the need to provide for the appropriate use of such credits or resources.

(b) Contracting parties applying restrictions under sub-paragraph (a) of this paragraph shall progressively relax them as such conditions improve, maintaining them only to the extent that the conditions specified in that sub-paragraph still justify their application. They shall eliminate the restrictions when conditions would no longer justify their institution or maintenance under that sub-paragraph.

3. (a) Contracting parties undertake, in carrying out their domestic policies, to pay due regard to the need for maintaining or restoring equilibrium in their balance of payments on a sound and lasting basis and to the desirability of avoiding an uneconomic employment of productive resources. They recognize that in order to achieve these ends, it is desirable so far as possible to adopt measures which expand rather than contract international trade.

(b) Contracting parties applying restrictions under this Article may determine the incidence of the restrictions on imports of different products or classes of products in such a way as to give priority to the importation of those products which are more essential.

(c) Contracting parties applying restrictions under this Article undertake:

(i) to avoid unnecessary damage to the commercial or economic interests of any other contracting party:

(ii) not to apply restrictions so as to prevent unreasonably the importation of any description of goods in minimum commercial quantities the exclusion of which would impair regular channels of trade: and

(iii) not to apply restrictions which would prevent the importation of commercial samples or prevent compliance with patent, trade mark, copyright, or similar procedures.

(d) The contracting parties recognize that, as a result of domestic policies directed towards the achievement and maintenance of full and productive employment or towards the development of economic resources, a contracting party may experience a high level of demand for imports involving a threat to its monetary reserves of the sort referred to in paragraph 2(a) of this Article. Accordingly, a contracting party otherwise complying with the provisions of this Article shall not be required to withdraw or modify restrictions on the ground that a change in those policies would render unnecessary restrictions which it is applying under this Article.

4. (a) Any contracting party applying new restrictions or raising the general level of its existing restrictions by a substantial intensification of the measures applied under this Article shall immediately after instituting or intensifying such restrictions (or, in circumstances in which prior consultation is practicable, before doing so) consult with the CONTRACTING PARTIES as to the nature of its balance of payments difficulties, alternative corrective measures which may be available, and the possible effect of the restrictions on the economies of other contracting parties.

(b) On a date to be determined by them, the CONTRACTING PARTIES shall review all restrictions still applied under this Article on that date. Beginning one year after that date, contracting parties applying import restrictions under this Article shall enter into consultations of the type provided for in sub-paragraph (a) of this paragraph with the CONTRACTING PARTIES annually.

(c) (i) If, in the course of consultations with a contracting party under sub-paragraph (a) or (b) above, the CONTRACT-

ING PARTIES find that the restrictions are not consistent with the provisions of this Article or with those of Article XIII (subject to the provisions of Article XIV), they shall indicate the nature of the inconsistency and may advise that the restrictions be suitably modified.

(ii) If, however, as a result of the consultations, the CONTRACTING PARTIES determine that the restrictions are being applied in a manner involving an inconsistency of a serious nature with the provisions of this Article or with those of Article XIII (subject to the provisions of Article XIV) and that damage to the trade of any contracting party is caused or threatened thereby, they shall so inform the contracting party applying the restrictions and shall make appropriate recommendations for securing conformity with such provisions within a specified period of time. If such contracting party does not comply with these recommendations within the specified period, the CONTRACTING PARTIES may release any contracting party the trade of which is adversely affected by the restrictions from such obligations under this Agreement towards the contracting party applying the restrictions as they determine to be appropriate in the circumstances.

(d) The CONTRACTING PARTIES shall invite any contracting party which is applying restrictions under this Article to enter into consultations with them at the request of any contracting party which can establish a *prima facie* case that the restrictions are inconsistent with the provisions of this Article or with those of Article XIII (subject to the provisions of Article XIV) and that its trade is adversely affected thereby. However, no such invitation shall be issued unless the CONTRACTING PARTIES have ascertained that direct discussions between the contracting parties concerned have not been successful. If, as a result of the consultations with the CONTRACTING PARTIES, no agreement is reached and they determine that the restrictions are being applied inconsistently with such provisions, and that damage to the trade of the contracting party initiating the procedure is caused or threatened thereby, they shall recommend the withdrawal or modification of the restrictions. If the restrictions are not withdrawn or modified within such time as the CONTRACTING PARTIES may prescribe, they may release the contracting party initiating the procedure from such obligations under this Agreement towards the contracting party applying the restrictions as they determine to be appropriate in the circumstances.

(e) In proceeding under this paragraph, the CONTRACTING PARTIES shall have due regard to any special external factors adversely affecting the export trade of the contracting party applying restrictions.

(f) Determinations under this paragraph shall be rendered expeditiously and, if possible, within sixty days of the initiation of the consultations.

5. If there is a persistent and widespread application of import restrictions under this Article, indicating the existence of a general disequilibrium which is restricting international trade, the CONTRACTING PARTIES shall initiate discussions to consider whether other measures might be taken, either by those contracting parties the balances of payments of which are under pressure or by those the balances of payments of which are tending to be exceptionally favourable, or by any appropriate intergovernmental organization, to remove the underlying causes of the disequilibrium. On the invitation of the CONTRACTING PARTIES, contracting parties shall participate in such discussions.

APPENDIX C

DECLARATION ON TRADE MEASURES TAKEN FOR BALANCE-OF-PAYMENTS PURPOSES

Adopted on 28 November 1979

The *CONTRACTING PARTIES*,

Having regard to the provisions of Articles XII and XVIII:B of the General Agreement;

Recalling the procedures for consultations on balance-of-payments restrictions approved by the Council on 28 April 1970 (BISD, Eighteenth Supplement, pages 48-53) and the procedures for regular consultations on balance-of-payments restrictions with developing countries approved by the Council on 19 December 1972 (BISD, Twentieth Supplement, pages 47-49);

Convinced that restrictive trade measures are in general an inefficient means to maintain or restore balance-of-payments equilibrium;

Noting that restrictive import measures other than quantitative restrictions have been used for balance-of-payments purposes;

Reaffirming that restrictive import measures taken for balance-of-payments purposes should not be taken for the purpose of protecting a particular industry or sector;

Convinced that the contracting parties should endeavour to avoid that restrictive import measures taken for balance-of-payments purposes stimulate new investments that would not be economically viable in the absence of the measures;

Recognizing that the less-developed contracting parties must take into account their individual development, financial and trade situation when implementing restrictive import measures taken for balance-of-payments purposes;

Recognizing that the impact of trade measures taken by developed countries on the economies of developing countries can be serious;

Recognizing that developed contracting parties should avoid the imposition of restrictive trade measures for balance-of-payments purposes to the maximum extent possible,

Agree as follows:

1. The procedures for examination stipulated in Articles XII and XVIII shall apply to all restrictive import measures taken for balance-of-payments

purposes. The application of restrictive import measures taken for balance-of-payments purposes shall be subject to the following conditions in addition to those provided for in Articles XII, XIII, XV and XVIII without prejudice to other provisions of the General Agreement:

(*a*) in applying restrictive import measures contracting parties shall abide by the disciplines provided for in the GATT and give preference to the measure which has the least disruptive effect on trade [1];

(*b*) the simultaneous application of more than one type of trade measure for this purpose should be avoided;

(*c*) whenever practicable, contracting parties shall publicly announce a time schedule for the removal of the measures.

The provisions of this paragraph are not intended to modify the substantive provisions of the General Agreement.

2. If, notwithstanding the principles of this Declaration, a developed contracting party is compelled to apply restrictive import measures for balance-of-payments purposes, it shall, in determining the incidence of its measures, take into account the export interests of the less-developed contracting parties and may exempt from its measures products of export interest to those contracting parties.

3. Contracting parties shall promptly notify to the GATT the introduction or intensification of all restrictive import measures taken for balance-of-payments purposes. Contracting parties which have reason to believe that a restrictive import measure applied by another contracting party was taken for balance-of-payments purposes may notify the measure to the GATT or may request the GATT secretariat to seek information on the measure and make it available to all contracting parties if appropriate.

4. All restrictive import measures taken for balance-or-payments purposes shall be subject to consultation in the GATT Committee on Balance-of-Payments Restrictions (hereafter referred to as " Committee ").

5. The membership of the Committee is open to all contracting parties indicating their wish to serve on it. Efforts shall be made to ensure that the composition of the Committee reflects as far as possible the characteristics of the contracting parties in general in terms of their geographical location, external financial position and stage of economic development.

6. The Committee shall follow the procedures for consultations on balance-of-payments restrictions approved by the Council on 28 April 1970 and set

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[1] It is understood that the less-developed contracting parties must take into account their individual development, financial and trade situation when selecting the particular measure to be applied.

out in BISD, Eighteenth Supplement, pages 48-53, (hereinafter referred to as " full consultation procedures ") or the procedures for regular consultations on balance-of-payments restrictions with developing countries approved by the Council on 19 December 1972 and set out in BISD, Twentieth Supplement, pages 47-49, (hereinafter referred to as " simplified consultation procedures ") subject to the provisions set out below.

7. The GATT secretariat, drawing on all appropriate sources of information, including the consulting contracting party, shall with a view to facilitating the consultations in the Committee prepare a factual background paper describing the trade aspects of the measures taken, including aspects of particular interest to less-developed contracting parties. The paper shall also cover such other matters as the Committee may determine. The GATT secretariat shall give the consulting contracting party the opportunity to comment on the paper before it is submitted to the Committee.

8. In the case of consultations under Article XVIII:12 (*b*) the Committee shall base its decision on the type of procedure on such factors as the following:

(*a*) the time elapsed since the last full consultations;

(*b*) the steps the consulting contracting party has taken in the light of conclusions reached on the occasion of previous consultations;

(*c*) the changes in the overall level or nature of the trade measures taken for balance-of-payments purposes;

(*d*) the changes in the balance-of-payments situation or prospects;

(*e*) whether the balance-of-payments problems are structural or temporary in nature.

9. A less-developed contracting party may at any time request full consultations.

10. The technical assistance services of the GATT secretariat shall, at the request of a less-developed consulting contracting party, assist it in preparing the documentation for the consultations.

11. The Committee shall report on its consultations to the Council. The reports on full consultations shall indicate:

(*a*) the Committee's conclusions as well as the facts and reasons on which they are based;

(*b*) the steps the consulting contracting party has taken in the light of conclusions reached on the occasion of previous consultations;

(*c*) in the case of less-developed contracting parties, the facts and reasons on which the Committee based its decision on the procedure followed; and (*d*) in the case of developed contracting parties, whether alternative economic policy measures are available.

If the Committee finds that the consulting contracting party's measures

(*a*) are in important respects related to restrictive trade measures maintained by another contracting party [1] or

(*b*) have a significant adverse impact on the export interests of a less-developed contracting party,

it shall so report to the Council which shall take such further action as it may consider appropriate.

12. In the course of full consultations with a less-developed contracting party the Committee shall, if the consulting contracting party so desires, give particular attention to the possibilities for alleviating and correcting the balance-of-payments problem through measures that contracting parties might take to facilitate an expansion of the export earnings of the consulting contracting party, as provided for in paragraph 3 of the full consultation procedures.

13. It the Committee finds that a restrictive import measure taken by the consulting contracting party for balance-of-payments purposes is inconsistent with the provisions of Articles XII, XVIII:B or this Declaration, it shall, in its report to the Council, make such findings as will assist the Council in making appropriate recommendations designed to promote the implementation of Articles XII and XVIII:B and this Declaration. The Council shall keep under surveillance any matter on which it has made recommendations.

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[1] It is noted that such a finding is more likely to be made in the case of recent measures than of measures in effect for some considerable time.

The **Chairman**. We follow a first-come first-serve rule and Senator Bentsen was here slightly before I was this morning.

Lloyd?

Senator **Bentsen**. Thank you very much, Mr. Chairman. I have known Bob Galvin a long time. I know him as one of the most progressive businessmen that I know, a broad-gauged man. I think he has rather dramatically presented what the problem is. I think it's absolutely imperative that we try to encourage the five major financial market countries to do some intervention to try to get this dollar back in balance.

I think it's imperative that the President show leadership on trade policy; we haven't had a trade policy under the Republicans or Democrats. Our trade policy has to be a coordinated policy. Trade policy is important because without it, we are eroding the manufacturing base, and we can't remain a great Nation unless we keep that manufacturing base.

I would also say to my friend Bob Galvin and to business leaders that I think we are going to turn it around because I don't think we have any choice. Don't get too many of those plants overseas because maybe you would have some problems getting back in. Some actions are going to be taken here, I believe, to try to even that playing field.

And I know the chairman of this committee shares a lot of that concern. And I know he's going to be searching, just like I am, trying to see what we can do because I know if we lose the market share, if you lose these companies, we will have one heck of a time ever getting them back.

I was talking to the head of a large company. He said, "We are moving overseas and just saying, 'preserve the market share.' " The trouble is when they make a $100 million or so investment over there, it's very tough to abandon that and come back.

I'm concerned, though, Mr. Galvin with the comment of the surcharge. I've looked at that a number of times, but I think you get instant retaliation if you do that. Then all the industries seem to turn down in every econometric model I've seen. So I have backed away from that one.

Could you comment on that?

Mr. **Galvin**. Well, I think what we must all deal with primarily—at least I'm only capable of dealing with my opinion, a function of some degree of interplay with people who are overseas. And I believe the determinative factor is that this market is so important to those that might feel the most touched by the issue that after they have waxed strong, as anyone must in an argumentative position, if policy were effected I don't think that they would cut off their nose to spite their face in terms of maintaining access to this market to the optimum degree that they can.

For example, I think that our most notable trading competitor, the Japanese, are very likely to absorb a good deal of whatever would be the cost of this matter. I think some of the Europeans would do the same thing. They would recognize that it is a temporary measure. Frankly, some of them say to us privately that we recognize you had better do something about it, and if this would have some effect on daunting the value of the dollar, maybe for a short while we could suffer it.

So I don't see this as being something that would generate anything more than a great deal of noise about retaliation and some papered-over retaliation. But that does not happen to be the principal concern that I have.

Senator BENTSEN. Well, in part, it's a tax you are talking about. I would assume that if you've a choice between that and some kind of a value-added tax you would choose the value-added-tax approach.

Mr. GALVIN. I would. If one could move with tax policy rapidly and put that into effect without ever having to go through a stage such as a surcharge, that would clearly be my preference.

Senator BENTSEN. Well, one of the things that I'm looking at is Superfund. We have got a problem with Superfund. And I am trying to see that the burden is equitably shared. The petrochemcial industry and oil industry carries virtually all of the burden. But I'm looking at a manufacturers' excise tax, and that would be one that would be added on but taken off of anything that was exported. And, in turn, added on anything that was imported in trying to fund Superfund.

I assume that that is the kind of approach you are talking about. Not carried as far as you are saying. More like the Canadian manufacturers' excise tax.

Mr. GALVIN. I'm not familiar with the details of that particular aspect. Really only competent in dealing with the generalization that I think what we have to have is some form of a tax policy and practice that is rather similar, if not exactly the same, as many of our trading competitors where they do have tax forgiveness at their border when they send their products over to us, and vice versa when they come in there would be the compensatory tax.

And, incidentally, all of them pretty much say, well, if you do that, we have no problem with that. The Japanese I have talked to said we have been recommending it to you for years.

Senator BENTSEN. Thank you very much, Mr. Galvin.

The CHAIRMAN. Do I sense, Mr. Galvin, that you think the effect of either a surcharge or a value-added tax would be about the same, and you would rather have the value-added tax, given your druthers?

Mr. GALVIN. Yes, sir.

The CHAIRMAN. What do you think about the step we are attempting to take in the Senate right now in terms of our budget process and the rather major cuts we are about to undertake, if we do it?

Mr. GALVIN. I'm thrilled that you are taking the effort. I'm concerned that they are insufficient, and as a consequence of my evaluation of their insufficiency—and I recognize your political realities—it seems to us that the augmentation by a surcharge or a value-added tax would be another important step at blunting what we consider to be the effect of the deficit on interest rates, on the value of the dollar, and that entire chain of theory.

The CHAIRMAN. I assume your support for the value-added tax or perhaps some variation in the tax—the tax that Senator Bentsen refers to is a form of a consumption business tax—your support for that would be limited to that kind of a tax. You are not suggesting any tax increase. Not an increase in corporate profits tax or something like that to make up the difference.

Mr. GALVIN. Correct, sir.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I apologize for being late. I want to welcome Mr. Galvin. I will pay great attention when I read his testimony.

The CHAIRMAN. Any other questions, Lloyd?

Senator BENSTEN. No, Mr. Chairman. Mr. Galvin has been very helpful to us in other committees, too.

The CHAIRMAN. Mr. Galvin, thank you very much.

Mr. GALVIN. Thank you, gentlemen.

The CHAIRMAN. Now we will take Dr. Rudolph Penner, the Director of the Congressional Budget Office; Dr. Lawrence Klein from the University of Pennsylvania and a Nobel Prize winner; and Mr. Craig Elwell from the Library of Congress.

Dr. Penner, I've had a phone call from Pete Domenici and I know he wants you back. I can't understand why he needs you so urgently this morning. We have nothing going on that would affect the Budget Committee or you, but on his request I think I'll ask you to testify and let us ask you questions and then run back to the chairman of the Budget Committee.

Senator MOYNIHAN. Mr. Chairman, I would like to suggest that you excuse Dr. Penner. I don't think the three of us are equal to the three of them. [Laughter.]

The CHAIRMAN. Well, if they lose Dr. Penner, it's the three of us against the two of them.

Senator MOYNIHAN. That's my thought. All right.

STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Dr. PENNER. I think that's all right, sir.

Shall I proceed, sir?

The CHAIRMAN. Yes; go right ahead.

Dr. PENNER. It is a pleasure to be here today, Mr. Chairman. I'll very briefly summarize our more complete study.

The Congressional Budget Office [CBO] believes that the growing U.S. budget deficit has attracted capital from abroad thus raising the foreign exchange value of the dollar and seriously damaging the competitiveness of U.S. export- and import-competing industries. An across-the-board import surcharge would be no panacea for these problems. If everyone believed that an import surcharge were to be permanent and if there were no foreign retaliation to the surcharge, in our judgment, it would have the following effects:

A rise in the value of the dollar and a decline in foreign real GNP; thus hurting U.S. exporters such as in agriculture;

An ambiguous effect on U.S. interest rates because of offsetting factors;

A rise in the price of imports and import competing goods, thus hurting consumers and industries that use these goods as inputs;

A rise in the demand for products of industries that compete with imports, thus helping those industries;

A fall in the U.S. budget deficit;

An improvement in the U.S. trade and current account deficits if the dollar did not strengthen too much.

These conclusions assume that the tariff will not have either a very large contractionary or expansionary impact on U.S. economic activity and that whatever impact on employment occurs, it will not be large and can be offset by modest changes in monetary policy.

The reason for this assumption is as follows:

The tariff has two opposite effects on aggregate demand in the United States. As a tax, some of which will burden foreigners, it reduces U.S. and foreign private incomes and so reduces the demand for U.S. products. But it raises the U.S. price of foreign products relative to that of American products, and so gives the latter a competitive advantage. Americans will substitute purchases of U.S. goods for foreign goods, and this has an expansionary impact.

The assumption that these two effects come close to canceling each other out allows us to concentrate on the efficiency effects of the tariff, which are clearly detrimental to the U.S. economy.

Some analysts place a great deal more emphasis on the effects of a tariff on aggregate demand. For example, our careful analysis of the study by Data Resources, Inc., an attachment to this testimony, concludes that the tariff would have a net contractionary impact of some significance that would be offset after some time lag by an expansionary monetary policy.

The economy would recover rapidly after the surtax is removed. In fact, it would actually attain a higher level of performance in the longer run because of the imposition and the quick removal of the surtax.

It is difficult to disentangle the effects of the surtax and the expansionary monetary policy in this simulation and the effects of both can be changed significantly by small changes in the assumption.

In particular, my complete testimony illustrates that if the tariff is believed to be temporary, a wide range of behavioral responses is possible and the conclusions of the analysis can vary greatly, depending on which set of responses is presumed to dominate.

None of this analytic work explicitly considers the possibility of retaliation. We see retaliation as the greatest danger of imposing a large tariff. A trade war could devastate the world economy, leaving everyone very much worse off than they are today.

Thank you very much.

[The prepared statement of Dr. Rudolph G. Penner follows:]

Statement of
Rudolph G. Penner
Director
Congressional Budget Office

before the
Committee on Finance
United States Senate

April 24, 1985

There should be no release of this statement until its delivery, scheduled for 9:30 a.m. (E.S.T.) Wednesday, April 24, 1985.

SUMMARY OF STATEMENT BY RUDOLPH G. PENNER
DIRECTOR, CONGRESSIONAL BUDGET OFFICE
BEFORE THE COMMITTEE ON FINANCE,
U.S. SENATE—APRIL 24, 1985

It is CBO's belief that the growing U.S. budget deficit has attracted capital from abroad, thus raising the foreign exchange value of the dollar and seriously damaging the competitiveness of U.S. export and import-competing industries. An across-the-board import surcharge would be no panacea for these problems. If everyone believed that an import surcharge were to be permanent, and if there were no foreign retaliation to the surcharge, it would have the following effects:

- A rise in the value of the dollar and a decline in foreign real GNP, thus hurting exporters;
- An ambiguous effect on U.S. interest rates because of offsetting factors;
- A rise in the price of imports and import-competing goods, thus hurting consumers and industries that use these goods as inputs;
- A rise in demand for products of industries that compete with imports, thus helping those industries;
- A fall in the U.S. budget deficit;
- An improvement in the U.S. trade and current account deficits (if the dollar did not strengthen too much).

The greatest threat posed by the proposed surcharge is a trade war that would unquestionably reduce the well-being of all concerned. The proposed import surcharge would actually raise the average tariff for all imported goods above the average level attained by the Smoot-Hawley Tariff Act of 1930.

Mr. Chairman, it is a pleasure to appear before this Committee to discuss the proposal for an import surcharge as one means of compensating for the effects of real dollar appreciation on U.S. international trade. The tremendous growth in the U.S. trade deficit over the last three years has been the consequence of a number of factors, including strong economic growth in the United States relative to that in the rest of the world. It is CBO's belief, however, that the growing U.S. budget deficit has been an important factor in the deterioration of the U.S. trade balance, as the burgeoning flow of public debt has raised interest rates and thereby attracted capital from international capital markets. That, in turn, has raised the foreign exchange value of the U.S. dollar and seriously damaged the competitiveness of U.S. export and import-competing industries. Some groups would counter the effects of the budget deficit with a temporary surcharge on all U.S. imports in the hope that it would protect U.S. industries, reduce U.S. demand for foreign exports, lower the U.S. trade and current account deficits, and depreciate the dollar, while directly providing revenues to reduce the budget deficit.

My testimony today evaluates these claims. No doubt an import surcharge on the order of 20 percent would have significant effects on the federal deficit, the trade and current account balance, domestic and foreign inflation, domestic and foreign real GNP growth, and the efficiency of resource utilization both at home and abroad. Unfortunately, this last point is one that is often slighted in discussions of an import surcharge.

Consequently, my testimony begins with a qualitative assessment that emphasizes the nature of the efficiency costs. A more detailed and rigorous evaluation can be found in Attachment A.

SUMMARY OF QUALITATIVE ASSESSMENT

Economists have long extolled the gains from free international trade. It allows countries to concentrate their scarce resources on the production of goods where they are relatively efficient and then to use those goods in trade with other countries to obtain goods that, because of climate or other factors, could not be produced in their own country at all or that could only be produced at relatively high cost. Thus, international trade increases the efficiency of world production by allowing specialization and generally increases the welfare of all participating countries.

Not all individuals within countries will necessarily gain from international trade, however. As countries specialize more, the demand for some types of labor, capital, or land increases while it is reduced for others. But the winners win much more than the losers lose, and the former could easily compensate the latter for their losses while still enjoying a net gain in their own welfare. Unfortunately, it is difficult to arrange such transfers of income in practice, and one often hears demands for protection from groups of those who are hurt. Since such groups are often successful, all countries resort to some degree of protection despite the obvious advantages of free trade. Nevertheless, since World War II there has been a strong trend toward a world of increasingly free trade.

The foregoing analysis rests on a number of simplifying assumptions, and there can be exceptions to the rule that countries are likely to lose if they impose tariffs or other barriers to free trade. Only the most important exceptions are discussed here, while others are analyzed in Attachment A.

The two most important assumptions implicitly made above are: first, that labor and capital are fully employed in all countries; and second, that the situation is not complicated by changing international capital flows.

If there is full employment, any increase in the output of the goods that a country produces less efficiently must be offset by reduced output of the goods that a country produces most efficiently. But suppose that unemployment exists in a country. Can it use a tariff to increase the output of goods it produces less efficiently while not losing any output in its most efficient industries?

A tariff has two opposite effects on aggregate demand within a country. First, a tariff is, in essence, an excise tax and, like any other tax, it reduces private income. But some part of the reduction in income resulting from a U.S. tariff may be shifted onto other countries. To the extent that this happens, overall demand for U.S. goods will be reduced as foreign countries can afford to buy less of our exports. In the most likely case, however, the prices charged by foreign exporters will not fall by the entire amount of the tariff. Some of the tax will be paid by U.S. residents, and they will have less income to spend on U.S. products. At the same time, since the tariff will raise the price of foreign products relative to that of competing U.S. products, it will divert demand toward the latter. Since it is not clear which effect will predominate—that of lower U.S. and foreign private income or the better competitive position of certain U.S. products—U.S. employment could either rise or fall. Of course, none of these effects considers the possibility of retaliation. If that occurs, employment is almost certain to fall in all countries.

More important, the complexity of the effects outlined above illustrates that the imposition of a tariff aimed at manipulating U.S. employment would be an awkward and uncertain endeavor. There are more direct approaches to manipulating employment. In the current environment, monetary policy provides a most important option.

In the remainder of this section of my testimony, it will be assumed that monetary policy is directed toward certain employment goals and that it offsets any employment effects—positive or negative—of a tariff. That is, of course, a vast oversimplification. Monetary policy has many goals other than manipulating employment, the control of inflation being the most important. Moreover, even if employment were its only goal, the degree of fine tuning implied by our assumption would be extremely difficult, if not impossible, to obtain in practice. But the assumption that employment is held constant may not be far from the truth, and it is convenient analytically because it allows CBO to focus on other effects of a surcharge in the base case.

In addition, it will be assumed initially that there will be no foreign retaliation in response to new U.S. tariffs and that everyone believes that the tariff will be permanent despite any official claims to the contrary. This then leaves the difficult problem of what happens to international capital flows.

Some would argue that, if employment is assumed to be constant, the tariff, by reducing the U.S. budget deficit, will reduce U.S. interest rates, thus causing an increased outflow or lowered inflow of international capital. This effect could be offset, however, by foreign producers' deciding to circumvent the new tariff wall by moving production to the United States. Although foreign producers could, in theory, finance new U.S. production facilities by drawing on U.S. capital markets (an attractive option, if U.S. interest rates actually fall), they may also bring some foreign financing with them. Moreover, the situation is confounded further by uncertainty about what happens to foreign interest rates in response to any fall in U.S. rates.

Consequently, given these simplifying assumptions, changes in international capital flows could, by themselves, exert either upward or downward pressure on the value of the U.S. dollar. It is CBO's judgment, however, that the effects would not be large either way and that the change the value of the U.S. dollar would be dominated by the tariff's effect on trade flows. As a result, the foreign exchange value of the U.S. dollar is sure to rise. The reason is that the amount of dollars paid to foreigners for imports will fall either because the world price falls by the entire amount of the tariff or because the tariff raises the U.S. price of the goods and the quantity demanded falls. In most cases, it is reasonable to expect some fall in the price paid to foreign producers and some rise in the price paid by U.S. buyers, with the size of each effect varying greatly from product to product. 1/

In summary, under the simplifying assumptions made thus far, the most likely effects of a tariff would be:

- a rise in the value of the U.S. dollar, which would hurt U.S. exporters;
- a rise in the U.S. price of imports and competing goods, which would hurt heavy consumers of imports and industries that use imports or competing goods as inputs;
- a rise in the demand for the products of industries that compete with imports, which would help those industries; and
- a fall in the U.S. budget deficit because of the revenue implications of the tariff.

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1. To the extent that the world price of imported goods falls, there is a benefit to the welfare of the importing country. In theory, this effect can be large enough to more than offset the loss in efficiency imposed by the tariff. This possibility provides an exception to the rule that tariffs reduce domestic welfare. But to obtain this result, the tariff has to be set at precisely the right level, and that level varies from good to good. It is extremely unlikely that an across-the-board tariff could result in such a welfare gain.

The effects of a tariff on the industrial composition of U.S. output are considered in more detail in the last section of this testimony.

The effect of a tariff on U.S. interest rates is ambiguous. Beneficial effects will result from reducing the budget deficit and from any increase in the supply of foreign capital accompanying foreign investment in production facilities that are designed to circumvent the tariff wall. On the other hand, if the tariff has a net expansionary impact, by assumption it will be countered by a contractionary monetary policy in order to keep employment constant.

Thus far, this analysis has not considered the possibility of retaliation in detail. Because the United States is so important in world trade, it is almost certain that a surcharge will result in a significant loss of economic welfare for the rest of the world. Since the major trading partners of a large, tariff-raising country unambiguously suffer losses in economic welfare, they have every motivation to band together to raise their own tariff or nontariff barriers to trade vis-a-vis the large country. The precise effects of this retaliation depend on the height and the type of trade barriers that are raised, which are almost impossible to predict. It is doubtful, however, that the trading partners will be able to raise their welfare back to its initial level before the surcharge was imposed. The large country may be able to improve its economic welfare somewhat by imposing the import surcharge. After foreign retaliation, however, the large country is almost certain to suffer a net loss in economic welfare compared with its initial, presurcharge situation. Hence, even though there is a possibility that one or another country may enjoy a net gain in economic welfare after retaliation, the most likely outcome is that all countries will be worse off than they were initially.

Of course, the possibility exists that retaliation may lead to counter-retaliation, and ultimately to a trade war. The volume of world trade, already depressed prior to retaliation, would decline even further, and the internal distribution effects would likely be more severe. In fact, if retaliation escalates, the volume of trade between the large country and the rest of the world could dwindle to almost nothing. The end result would be a drastic reduction in economic welfare for both the United States and its trading partners.

Retaliation also might take forms other than the imposition of tariffs against U.S. products. Angry allies might contribute less to mutual defense or take other actions designed to make life painful for the United States.

The foregoing analysis has assumed that private economic agents expect a U.S. import surcharge to be permanent. If people making economic decisions believe that a U.S. import surcharge would be only temporary, these conclusions could change considerably.

One possibility is that U.S. citizens might not change their consumption behavior at all, but would absorb the full impact of the temporary surcharge by dipping into their savings. If real expenditures on imports did not decline, there would be no positive expenditure-switching effects. Moreover, there would not be a direct contractionary fiscal-policy effect, because the temporary decline in private savings would fully counteract the loss in purchasing power caused by higher tariff collections. A surcharge would reduce the federal deficit more since tariff revenues would remain at a high level as long as the import surcharge stays in place. This reduced federal deficit is unlikely to have any significant effect on real interest rates, however, because it would be offset by the fall in private savings.

This is not the only possible outcome, of course, because not all U.S. citizens may be willing to sustain higher spending on imports. For instance, manufacturers who use imported inputs in their production processes may simply postpone purchases from abroad. If the majority of importers postpone their import purchases until the surcharge is lifted, and if simultaneously U.S. citizens conclude that American goods are poor substitutes for import goods, a number of conclusions would change dramatically. The U.S. trade balance and current account balance would improve sharply. The expenditure-switching effect would be muted because of the limited acceptability of American substitutes. But there would be only a slight direct contractionary fiscal-policy effect because postponed import spending yields no tariff revenues. Nonetheless, the rise in the private-saving ratio would lower domestic interest rates somewhat, and this would indirectly raise U.S. real GNP. As a result, there would be some improvement in the federal deficit.

Other forces, however, work to confuse the issue further. If private markets expect a U.S. import surcharge to be truly temporary, foreigners who might engage in direct investment in the United States would know that there would be no permanent tariff wall to protect U.S. markets in the future.

Because a U.S. import surcharge would reduce foreign real GNP significantly, the greatest threat posed by the proposed import surcharge is a trade war, which would unquestionably reduce the well-being of all concerned. History demonstrates the plausibility of a retaliatory tariff scenario. When the United States passed the Smoot-Hawley Tariff Act of 1930, many foreign countries imposed substantial tariffs of their own. Smoot-Hawley raised tariff levels on dutiable imported goods to an average level of 53 percent in 1932, an increase of 33 percent over 1929 levels. Retaliation led to a downward spiral in international trade, and U.S. exports as a percentage of GNP fell by close to one-half between 1929 and 1932. The proposed import surcharge would actually raise the average tariff for all imported goods above the average levels attained by the Smoot-Hawley Tariff Act. At each step of the retaliatory process, a country raising its trade barriers may either raise or lower its own real GNP somewhat, but the reduction in foreign real GNP is likely to be greater. Consequently, depending on how many retaliatory rounds are allowed, the reduction in world trade and world real GNP could be substantial. If retaliation were to accumulate and get out of hand, there would be a danger of serious worldwide economic decline.

The preceding discussion of the import surcharge has suggested that a quantitative assessment of the likely impacts of a proposed surcharge is a complex task. In this case, the factors conditioning the outcome include, among others, the degree to which foreign producers absorb the higher tariff by lowering their supply prices, the likelihood and extent of retaliation (resulting perhaps from some assumed movements in foreign incomes and production), the response of the domestic monetary authority, and, typically, changes in net capital flows. In evaluating the proposed surcharge, it is critical to examine the sensitivity of the model simulation results to changes in these (and perhaps other) conditioning factors. In addition, the choice of a particular model itself is a conditioning factor. The model must be robust in the sense that it must be flexible enough to incorporate such factors as, for example, the substitutability of imports for domestically produced goods.

A number of quantitative evaluations of import surcharge policies have recently been performed. In interpreting their results, the critical question pertains to the robustness of the conclusions. To explicate matters, I will adopt a specific example, a study published by Data Resources, Inc. (DRI). 2/

The DRI study examines the macroeconomic effects of a temporary import surcharge, phased out (20-15-7) over a three-year period. Their analysis assumes mitigating adjustments in the domestic money supply and no foreign retaliation. Simulation of the policy on the DRI quarterly macroeconomic model (over the 1986-1992 period) yields long-term improvement in both the federal deficit and the external trade balance at the expense of near-term adverse impacts on real output, employment, productivity, prices, and the exchange rate--adverse effects that are, however, decidedly reversed in the out-years after the surcharge is removed. Because of the improvement in real activity by 1992, along with a permanently lower debt-output ratio, the DRI results reflect relatively favorably on the surcharge proposal.

How robust are the DRI results? The Congressional Budget Office has completed a detailed examination of this question which is presented in Attachment B to this testimony. I will only summarize the CBO review here.

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2. See C. Caton, "The Effects of a Temporary Import Tariff," DRI Review of the U.S. Economy, March 1985, pp. 13-20.

The DRI study analyzes the import surcharge under a very specific set of conditioning factors. These factors include the assumptions that 50 percent of the surcharge is absorbed by foreign exporters, no foreign retaliation takes place, and the domestic monetary authority is passive initially in allowing the money supply to increase with the rise in the price level and takes a decidedly expansionary stance only when the economy has been significantly weakened. Since the study reports results for a single simulation using one set of conditioning factors, the study is only a partial evaluation of a surcharge policy.

Substitution of alternative conditions that are no less plausible is likely to lead to a substantially different outcome--a fact noted but not explored in the DRI study. For example, the CBO review concludes that the long-run optimistic results reported by DRI regarding real activity are most sensitive to the assumption regarding monetary policy. In particular, if an alternative, less expansionary response is assumed, the long-run gains in real activity reported by DRI are likely to be offset if not reversed.

Put another way, the crucial role assumed for monetary policy in the DRI simulation means that the simulation may reveal as much about the effects of a particular monetary stance, viewed in the confines of a very specific model, as it does about the effects of a surcharge. Unfortunately, there are few things that economists argue about more vigorously than the impact of changes in monetary policy. Relatively small, plausible changes in the structure of a model can greatly alter the results regarding its power and, therefore, all model results have to be viewed with a healthy dose of skepticism.

While the relative merits of any single set of assumptions may be a matter of debate, no quantitative analysis is possible without making this choice. In some policy simulations, conclusions remain the same under a wide variety of assumptions. Unfortunately, this is not the case in analyzing the effects of an import surcharge.

EFFECTS ON PARTICULAR U.S. INDUSTRIES

As already noted, an import surcharge would have very significant impacts on the composition of economic activity, as measured by production and employment in particular sectors. In general, industries directly competing with imports would tend to gain, while industries relying on either foreign inputs or export sales would tend to suffer. However, even this simple statement must be qualified. Many industries simultaneously fit into each of these categories; that is, they use foreign inputs, they export, and they directly compete with foreigners in the sale of their products to U.S. customers. The magnitude of employment and production effects for any specific industry depends on market conditions for its particular inputs and goods sold. For example, it would depend on the degree to which the import surcharge could be pushed back on foreign suppliers of inputs or on how responsive the consumers of the industry's products are to price increases.

By altering the prices and demands faced by individual industries, a series of interindustry adjustments would follow the imposition of a surcharge. These adjustments would take the form of movements of both workers and capital. Some workers would find better employment opportunities while others would be worse off. Moreover, since production costs would tend to increase and demand for outputs would respond to prices charged, even expanding industries might find that profits do not increase.

The potential for specific industry effects can be crudely seen in Tables 1 and 2, which list the largest importing and exporting industries (by value of shipments). As noted, industries competing for sales with imports are potentially helped, while industries relying on imports as an input are potentially hurt. Of the leading importing industries, intermediate products used in the production of other goods are very highly ranked. Oil and natural gas top the ranking. Any increase in the prices of these goods will tend to filter through the rest of the economy, raising prices elsewhere.

The least ambiguous effects of a surcharge relate to exporting industries. They will very likely be hurt. Foreign demand for their output will fall with reduced foreign incomes; their production costs will tend to rise if they use imported inputs; and the rising value of the dollar will make their products even more difficult to sell abroad. Furthermore, exporting industries would be the likely target of any foreign retaliation to a surcharge. Note that three important agricultural products--corn, wheat, and soybeans--are contained in the list of our top six exports. Clearly, agriculture would be badly hurt by a surcharge, as would be high value-added articles such as aircraft and computers. Automobiles are a special case since they are high on both the import and export list.

Precise estimation of the effects on individual industries is difficult. Nevertheless, past industry price, trade, and output behavior does allow for a crude ranking of the effects of an import surcharge. Using various statistical estimates of market responses, the CBO has simulated the effects of a surcharge on major manufacturing industries. Some industries, such as those producing iron and steel or petroleum products, appear to have both large output price increases and large increases in domestic production and are thus benefited; others such as paper and chemicals are much less affected in terms of either prices or outputs. As might be expected, the variation across industries is substantial.

TABLE 1. LEADING ITEMS IN U.S. GENERAL IMPORTS FROM THE WORLD IN 1984 (Customs value, in thousands of dollars)

Standard Industrial Classification Number	Description	1984
1311	Crude petroleum and natural gas	40,039,917
3711	Motor vehicles and passenger cars	36,980,202
2911	Petroleum refinery products	21,450,382
3714	Parts of motor vehicles	11,043,061
3312	Blast furnace and steel mills	10,122,957
3651	Radio and TV receiving sets	9,373,239
3674	Semiconductors and rectifiers	7,262,587
3339	Primary nonferrous metals	6,400,083
9800	United States' goods returned	5,629,161
3579	Office machines and typewriters	4,670,976
2621	Paper mill products	4,624,035
3662	Radio and TV communication equipment	4,198,883
3573	Electronic computing equipment	4,198,520
2369	Outerwear of textile materials	4,109,912
0173	Tree nuts	3,750,877
3915	Jewelers' materials	3,015,638
3861	Photographic equipment and supplies	2,974,625
2421	Lumber and other sawmill products	2,866,198
3679	Electronic components and accessories	2,788,121
9900	Miscellaneous commodities	2,783,340

SOURCE: U.S. Department of Commerce.

TABLE 2. LEADING ITEMS IN U.S. TOTAL EXPORTS TO THE WORLD IN 1984 (f.a.s. value, in thousands of dollars)

Standard Industrial Classification Number	Description	1984
3573	Electronic computing equipment	13,815,733
3714	Motor vehicle parts and accessories	8,869,752
3711	Motor vehicles and passenger cars	7,064,415
0115	Corn, unmilled (including seed)	7,043,789
0111	Wheat, unmilled	6,476,[illegible]10
3721	Aircraft	5,807,383
0116	Soybeans	5,438,161
3674	Solid state semiconductor devices	5,240,680
3728	Aircraft parts	5,144,522
2911	Petroleum refinery products	4,961,414
3900	Miscellaneous manufactures	4,800,624
2869	Industrial organic chemicals	4,800,303
1211	Bituminous coal and lignite	4,090,857
3531	Construction machinery	3,413,995
3662	Radio and television equipment	3,029,045
2819	Industrial inorganic chemicals	2,975,022
3533	Oil and gas field equipment	2,791,854
3569	General industrial machinery	2,757,304
9100	Waste and scrap	2,715,937
2821	Plastics materials and resins	2,660,683

SOURCE: U.S. Department of Commerce.

NOTE: f.a.s. = free alongside ship.

ATTACHMENT A

THE EFFECTS OF AN IMPORT SURCHARGE ON NATIONAL WELFARE: A QUALITATIVE ANALYSIS

Staff Working Paper
March 1985

The Congress of the United States
Congressional Budget Office

SUMMARY

International trade allows countries to specialize in the production of those things in which they have a comparative cost advantage, trading them for things they are relatively poor at producing. This specialization and exchange is of benefit to each country and harms no country. Trade is a positive-sum activity.

A U.S. surcharge of 20 percent on the value of imported goods, while benefiting some sectors of the economy, would unambiguously result in a net overall loss of worldwide economic efficiency and welfare by moving away from specialization and trade. The only real question is how this loss would materialize and who would bear its burden. In general, the country that imposes a restriction on its trade is likely to be one of the major losers as resources shift away from its most efficient (exporting) industries to less efficient (import-competing) industries that will be partly protected by the trade restriction.

The distribution, and even the form, of the welfare losses among countries is less clear. A small country imposing a tariff might have little effect on world prices and trade, and thus might bear nearly all of the losses itself. A large country, like the United States, might be able to shift part of the tariff burden onto the rest of the world by forcing down the world price of its imports (that is, forcing foreign producers to pay part of the tariff by

lowering their prices). This could conceivably be enough to at least offset the internal loss of economic efficiency resulting from the reallocation of resources away from low-cost industries to high-cost industries. By imposing the right tariff on each good imported, a large country might, in theory, even gain from protection. But it is unlikely that an across-the-board surcharge would have such an effect. Moreover, retaliation would be likely, and if that was followed by counter-retaliation everyone would be almost certain to lose, and by large amounts.

CAPITAL FLOWS AND EMPLOYMENT EFFECTS: THE BASE CASE

The above analysis draws largely on the pure theory of international trade, assuming full employment and easy substitution of resources and goods for one another in response to price changes. While many of the conclusions derived from this analysis are directly applicable to other situations, the effects of a surcharge become more complex in the context of a modern economy open to international capital flows and subject to some unemployment of labor and capital. These complexities relate largely to the potential effects the surcharge might have on international prices through exchange rate movements induced by capital flows, and on aggregate demand and supply. None of these complexities, however, would fundamentally change the results of the previous analysis.

To simplify the task of analyzing highly interrelated phenomena, the following analysis focuses on a base case that can later be modified. The base case is constructed so as to allow examination of the efficiency costs and sectoral effects of the surcharge. It assumes the following: no retaliation, no imposition of capital controls, and the use of the surcharge revenue to reduce the government budget deficit. In addition, private markets believe the surcharge to be permanent, despite official protestations to the contrary. This last assumption is necessary if the private sector is to be willing to undergo the adjustment costs necessary to reallocate resources and if foreigners are to consider direct investment in the United States as an alternative to trade. Finally, aggregate demand and real GNP are assumed to be unchanged. This assumption is derived from the fact that the surcharge would raise the domestic price of imports, thus encouraging the substitution of domestic goods for imported ones. At the same time, it would produce a contractive fiscal-policy effect by removing purchasing power from the economy. The substitution of domestic goods for imported goods would tend to raise total domestic output, whereas the contractive fiscal policy would tend to lower it. As a simplifying assumption, it is convenient to postulate that these opposite effects would offset one another.

Under these assumptions, if the surcharge had no immediate effect on exchange rates, it would: reduce foreign real GNP, lower the federal deficit, and improve the U.S. trade balance. But it would in fact have an effect on the exchange rate because the combined GNP of all other countries will fall relative to U.S. GNP, strengthening capital flows to the United States and putting upward pressure on the dollar. Even if capital flows were not responsive to the relative strengthening of the U.S. economy, but were instead solely reflective of trade financing needs, the foreign exchange value of the dollar would rise in response to the surcharge-induced decline in U.S. imports.

To the extent that the import surcharge was considered by some to be a remedy for an overvalued dollar, it would be partially self-defeating. Since the surcharge would lower foreign real GNP, import-competing industries might be helped but exporters would be worse off: the dollar would be stronger while foreign real incomes would be lower, thus reducing overseas demand for U.S. exports; and the U.S. price level would be higher, as a result of the surcharge itself and because of higher domestic prices of close substitutes. Indeed, the strength of the foreign feedback effect on U.S. exports might by itself lower U.S. real GNP, unless a stimulative monetary policy was used to achieve the base-case assumption of no change in aggregate demand and real GNP.

Under the base-case assumptions, the main impact of the surcharge would be on the composition of production and final demand. It would raise domestic prices of imports and import-competing goods, thereby increasing revenues of import-competing industries and the prices paid for resources used intensively in these industries. Conversely, industries that rely heavily on foreign imports would experience higher production costs, leading to fewer sales and ultimately less income. On the consumption side, higher costs of both imported and domestic products would cause welfare losses. Although the base case assumes no foreign retaliation, which restricts but far from eliminates the negative effect of the surcharge on U.S. exports, some negative effects could nonetheless be expected, as exporting industries would have to contend with a higher-valued dollar. Moreover, the foreign feedback effect mentioned earlier would also lower demand for U.S. export goods as lower incomes abroad translated into reduced foreign consumption. And, finally, should there be foreign retaliation in kind, the domestic compositional effects would be even more pronounced.

OTHER SCENARIOS

Some of the above conclusions could change if the surcharge was viewed as being truly temporary. One possibility is that consumers would not switch into domestic substitutes but would dip into savings to absorb the impact of the surcharge. This would reduce the stimulative effect discussed earlier. At the same time, continued spending on imports would bring in greater revenue to reduce the federal deficit. Since the effects of reduced private saving and the reduced public deficit would cancel each other out, no significant effect would be likely on real interest rates.

Another possibility is that import buyers would simply postpone their purchases in expectation that the tariff would elapse in three years (quite likely under a declining rate surcharge). In the extreme case, where most import purchases were postponed but U.S. citizens did not switch to domestic substitutes: the U.S. trade balance would improve dramatically, there would be no stimulative expenditure-switching effect, there would be no contractive fiscal policy effect because of the lack of tariff revenue, but the relative increase in private savings (as a result of postponed consumption) could lower interest rates.

Under either extreme possibility, the potential effects on capital flows and exchange rates are unclear. If GNP rose, capital inflows might be stimulated. But if the surcharge was viewed as temporary, foreigners might lack the incentive to jump the tariff wall and invest in the United States.

Finally, there is the possibility (indeed, history suggests the probability) of retaliation. Since the surcharge would impose large losses on other countries, they would have a strong incentive to retaliate (either individually or collectively) to recoup some of their losses. It is unlikely, however, that they could recoup much, and the most probable outcome is that everyone would be worse off. The volume of world trade would almost certainly decline, leading to even greater losses in economic efficiency and welfare.

It is quite possible that retaliation would lead to capital controls, heightened financial risk, and a reduction in foreign capital available to the United States. If so, U.S. interest rates could rise significantly, output and income would fall, and the federal debt would skyrocket.

INTRODUCTION

Economists have long extolled the gains from free international trade and decried the losses of economic efficiency that result from international barriers to trade. One of the purposes of this paper is to describe how a U.S. import surcharge would result in losses of economic efficiency, and consequently of welfare, for the world at large and for the United States in particular. Another purpose is to highlight the considerations that would be strategic in designing an analysis to evaluate the effects of a U.S. import surcharge.

The paper is divided into several sections. Section I considers the effects of an import surcharge from the viewpoint of the pure theory of international trade, which assumes a world without money and without the possibility of short-run underemployment of labor and capital; Section I also assumes that foreign countries do not retaliate against a U.S. import surcharge by raising their own tariff or nontariff barriers to trade. Section II completes the discussion from the viewpoint of the pure theory of trade by considering the effects of a surcharge in the presence of foreign retaliation against the United States.

Section III expands the analysis to consider the effects of a surcharge on international capital flows and on employment of labor and capital in a monetary economy, but without the possibility of foreign retaliation. It is assumed in this part of the paper that private markets expect the import surcharge to be permanent despite official protestations to the contrary.

Given the great complexity of the real world, this section focuses on a base case under simplifying assumptions, and suggests how conclusions might be altered by changing some of the assumptions. Particular attention is paid to the compositional effects of an import surcharge on specific U.S. industries.

Section IV then considers what might happen if an import surcharge was perceived by private markets to be truly temporary. Section V concludes by considering the effects of foreign retaliation under real-world circumstances.

SECTION I: THE PURE THEORY OF INTERNATIONAL TRADE WITH NO RETALIATION

The pure theory of international trade describes a barter world in which there is no money, although goods exchange at relative prices very much as they do in a monetary economy, and the pricing system plays a key role in the allocation of real resources among alternative uses. The main difference between the monetary and the barter worlds is that, in the latter, prices of commodities are quoted in terms of other commodities rather than in terms of monetary units. 1/

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1. The price of a commodity I in terms of another commodity II indicates the amount of II that must be sacrificed or traded in order to obtain one unit of I; it is the ratio of the number of units of II per unit of I in a voluntary market exchange. The price of commodity II in terms of commodity I is simply a reciprocal of this ratio. The barter price of I in terms of II correponds to what in a monetary world would be the ratio of the money price of I to the money price of II. Barter prices are relative prices.

In the general case, the barter or pure theory of international trade assumes that labor and capital can be substituted for one another in the production process in varying degree as their relative prices change, and that consumers shift their purchases from one good to another as their relative prices change. The pure theory of international trade is more suited to analyzing the long-run effects of a tariff than the short-run effects. It assumes that labor and capital are fully employed, which limits its applicability to the short-run situation. Even with such limitations, however, many of the important conclusions from the barter or pure theory of trade are directly applicable to analysis of underemployment situations in a monetary economy with international capital flows.

The imposition of import tariffs obviously reduces the volume of world trade. If countries do not trade with one another at all, relative prices of commodities in each country depend on such things as their supply of natural resources; their climate; the size, quality, and composition of their physical capital stocks; the size, education, and skill levels of their labor force; and consumer preferences. If countries trade freely with one another, relative prices tend to equalize in the world market. Consequently, for any country, the prices of commodities that were relatively high without international trade are lowered under free trade through imports of lower-cost goods. Similarly, the prices of commodities that were relatively low are bid up under free trade, and more resources are shifted into their production for export markets.

The welfare gains from free trade result, therefore, from enabling countries to specialize in the production of those goods in which each has a comparative cost advantage. According to the principle of comparative advantage, international specialization results in higher total world output of goods and services, and it is very unlikely that any country will be made worse off than it would have been without international trade.

Another consequence of specialization according to the principle of comparative advantage is that those factors of production that are relatively most important to the production of export goods earn higher incomes. If the production of export goods is capital intensive, the return to capital rises relative to the wage rate for labor; if production of export goods is labor intensive, the wage rate rises relative to the return to capital. In moving from the no-trade situation to the free-trade situation, then, there will generally be some winners and some losers within each country, and different geographical regions of the country can be affected quite differently.

Thus, the welfare gain from free trade is a potential gain in that everyone could have either more of all goods or, alternatively, the same amount of all goods with more leisure. Free trade for a particular country is better than no international trade, in the sense that there exists some pattern of domestic taxes and transfer payments that would allow everyone to be better off than without trade. Those who wanted free trade could reward those opposed to it for agreeing to move from the no-trade to the free-trade situation, with the end result that everyone's welfare would be improved. Institutional restraints, however, often make it difficult to arrange such transfers in practice.

One relative price of particular importance to the barter theory is called "the terms of trade." It indicates the amount of import goods obtainable from one unit of exports, and can be thought of as reflecting the external purchasing power of exports. The introduction of tariffs on imports raises the domestic price to the consumer above the price charged on world markets--that is to say, above the price received by foreign producers.

In other words, the tariff causes the pattern of prices faced by consumers to move toward that which would exist without international trade, and consumers consequently shift their purchases toward import-competing goods. Because full employment is assumed, labor and capital must be drawn away from the export industries where they are used relatively efficiently and moved toward less efficient import-competing industries that have comparative cost disadvantages. As a result, there is an unambiguous loss of potential world welfare. In moving away from international specialization according to the principle of comparative advantage, potential world output of goods and services declines.

The distribution of the net loss of world welfare among countries is less clear. Even though an import surcharge almost certainly changes domestic prices, it may or may not change relative prices on world markets. If the country imposing the tariff is small compared with the rest of the world--or if its trade volumes are small relative to trade volumes for the rest of the world--then the tariff has essentially no effect on world prices. In this case, the total effect of the tariff is absorbed by the relative price of the country's import-competing goods, which must rise by the full amount of the tariff. Taking all markets into consideration, when the country imposing the import tariff has no effect on world prices, the net loss of world welfare is largely borne by the country imposing the tariff.

If the country imposing the import tariff is large enough to have a substantial impact on world prices, there are very special circumstances in which the tariff can result in a net gain of national welfare. If the country imposing the tariff has enough market power so that a fall in its purchases of imports depresses their world price relative to the price of its exports, the gain in import goods obtainable per unit of export goods can more than offset the internal loss of economic efficiency resulting from reallocation of real resources away from low-cost industries to high-cost industries. Although there may or may not be a gain in welfare for the large country imposing the tariff, there is an unambiguous net loss of potential welfare for the rest of the world, and for the world as a whole, because other countries are certain to lose more than the tariff-raising country gains.

A big country may be able to devise an "optimal" tariff structure that raises its national welfare at the expense of the rest of the world--that is, if foreign countries do not retaliate by raising their own tariff or nontariff barriers to trade. But in a world of many commodities and many factors of production, imposition of an optimal tariff structure would require an enormous amount of technical information relating to specific markets for internationally traded goods. Because market characteristics vary widely, an optimal tariff structure would generally consist of a complex system of subsidies as well as tariffs, of differing heights, imposed on export goods as well as on import goods. It is exceedingly unlikely that an across-the-board import surcharge would correspond to an optimal tariff structure for the United States.

Furthermore, regardless of whether the big country's economic welfare rises or declines on a net basis, an across-the-board surcharge results in substantial internal distributional effects under the assumption of full employment of capital and labor. In shifting resources from relatively low-cost industries to relatively high-cost industries, imposition of an import tariff raises the domestic prices of imports and import-competing goods, increases output of domestic import-competing industries, and raises the prices of factors of production that are relatively most important to the production of import-competing goods. At the same time, prices of export goods decline, fewer resources are devoted to export production, and the rewards of the factors of production that are relatively most important to those industries decline. On the consumption side, those domestic residents with a high propensity to consume imported and related goods lose, relatively speaking, because of the higher prices that they must pay for these goods.

SECTION II: THE PURE THEORY OF INTERNATIONAL TRADE WITH FOREIGN RETALIATION

If a small country imposes an import surcharge, the likelihood of foreign retaliation is relatively slim because the effect of the surcharge on the rest of the world will be small. But if the country imposing an import surcharge is large, it is almost certain that the surcharge will result in a significant loss of economic welfare for the rest of the world. When the big country succeeds in reducing the world price of its imports relative to its exports, it automatically lowers the amount of import goods that other countries can obtain per unit of their export goods. Moreover, the change in prices faced by the rest of the world shifts resources from their low-cost export industries into their high-cost import-competing industries, thereby creating efficiency losses abroad.

Since the major trading partners of a large, tariff-raising country unambiguously suffer losses in economic welfare, they have every motivation to band together to raise their own tariff or nontariff barriers to trade vis-a-vis the large country. The precise effects of this retaliation depend on the height and the type of the trade barriers that are raised, which are almost impossible to predict. It is possible that the retaliating countries may be able to improve their economic welfare somewhat relative to what they had experienced in the presence of the surcharge alone. It is much less likely, however, that they will be able to raise their welfare back to its initial level before the surcharge was imposed. As for the large country, it may have been able to improve its economic welfare somewhat by imposing the import surcharge, but, after foreign retaliation, it is almost certain to suffer a net loss in economic welfare relative to the initial, pre-surcharge situation. Hence, even though there is a possibility that the one or the other may enjoy a net gain in economic welfare after retaliation, the most likely outcome is that everybody will be worse off than initially.

The volume of world trade, already depressed by the imposition of a surcharge, will decline further as a consequence of retaliation. Moreover, even though relative prices on world markets may not change much, prices within countries will be changed significantly by higher tariffs. Hence, throughout the world, prices of export goods will be lower and prices of import-competing goods will be higher. As a result, the distributional effects within countries are likely to be more severe, as even more resources within each country are devoted to production of its relatively high-cost goods.

Of course, the possibility exists that retaliation may lead to counter-retaliation, and so on. An outcome of such a trade war will generally be that both the large country and the rest of the world will suffer losses in economic welfare. In fact, if retaliation escalates, the volume of trade between the large country and the rest of the world could dwindle to almost nothing, and the end result could be disastrous for world welfare.

SECTION III: CAPITAL FLOWS AND EMPLOYMENT EFFECTS CONSIDERED

The effects of an import surcharge become very much more complex and difficult to analyze for a modern monetary economy that is subject to international capital flows and underemployment of capital and labor. In this world, effective exchange rates are determined by the forces of demand and supply for national currencies used in international trade, and also for currencies used to conduct international capital transactions. As a result, imposition of an import surcharge may alter the relative prices of internationally traded goods indirectly through exchange-rate movements that are generated by induced capital flows. Moreover, underemployment of labor and physical capital allows for multiplier effects that magnify a policy shock, such as an import surcharge, into higher or lower levels of aggregate real output and disposable income. Thus, imposition of an import surcharge affects international trade not only through changes in relative prices but through changes in the economy's total output.

Given the great complexity of the situation, the following analysis focuses on a base case under a number of simplifying assumptions that allow unhindered examination of the efficiency costs of an import surcharge. It assumes that the major trading partners of the United States do not band together to retaliate against an import surcharge by raising their own tariff or nontariff barriers to trade. It further assumes that no country undertakes to control international capital flows or to tax international flows of investment income, and that nobody expects such developments.

In addition, the base case assumes that private markets expect a U.S. import surcharge to be permanent, despite official disclaimers to that effect. Consequently, the domestic private sector is willing to undergo adjustment costs associated with the reallocation of real resources among domestic industries. Similarly, foreigners who might engage in direct investment in the United States expect the tariff wall to protect U.S. markets permanently.

Imposition of a U.S. import surcharge raises the domestic price of imports, with two major direct effects on the domestic private economy. One is an expenditure-switching effect in response to change in relative prices, whereby domestic residents switch their spending from imports to domestic output. This would have an expansionary effect on the economy. The other is a contractionary fiscal-policy effect whereby the increase in tariff revenues immediately removes purchasing power from the domestic expenditure stream. In other words, the expansionary expenditure-switching effect is offset to some degree by a contractionary fiscal-policy effect.

If imports consisted entirely of goods that were very similar in all respects (except price) to domestically produced goods, it is quite possible that the expenditure-switching effect could overwhelm the contractionary fiscal-policy effect, and domestic output could rise substantially. At an opposite extreme, in a developing country where the range of possibilities for substitution between domestic output and imports is very limited or nil, the outcome would be very different. In fact, if imports provided necessary inputs to the domestic production process, domestic output would not only fall in response to a surcharge but could fall by more than the amount indicated by the contractionary fiscal-policy effect.

The truth for the United States undoubtedly lies somewhere between these two extremes. This particular question is an empirical one, left for the quantitative analysis. A study by Data Resources, Inc., suggests that the impact would be contractionary on balance. The next phase of this study will provide a detailed analysis and critique of the DRI study. The present qualitative analysis assumes that, before foreign feedback effects are taken into account, domestic expenditure switching would just offset the contractionary fiscal-policy effect, leaving domestic aggregate demand and real GNP unchanged. These assumptions are adopted solely for analytical convenience in isolating the direct efficiency costs created by an import surcharge. Alternatively, it could be assumed that monetary policy precisely offsets any net expansionary or contractionary effect that occurs. This might be appropriate if the monetary authorities pursue explicit goals for aggregate economic activity. In practice, however, such fine tuning is very difficult, and economic goals are constantly shifting in response to exogenous events and to changes in the structure of the economy.

Other effects of an import surcharge appear to be less ambiguous. Regardless of the direction of the effects on domestic aggregate demand and real GNP, an import surcharge reduces foreign real GNP, lowers the federal deficit, and improves the real U.S. trade balance. Since the surcharge lowers the world market price of imports, it also improves the nominal U.S. trade balance. Because the trade balance would improve at a constant exchange rate, then it follows that with no change in capital flows the dollar would appreciate.

It also appears that an import surcharge might improve the overall strength of the U.S. economy relative to the overall strength of the rest-of-the-world economy. If it lowered U.S. real GNP, moreover, the surcharge would be likely to lower foreign real GNP by more. 2/ It is quite possible, then, that an import surcharge could strengthen investment capital flows into the United States and thus lead to an even stronger dollar than the improvement in the trade balance alone would produce.

For the following analysis, however, a less extreme assumption is used: the total level of investment capital inflows into the United States is unaffected by the import surcharge and remains the same as in the absence of the surcharge. In this scenario, the effective exchange rate is determined by the strength of excess demand for dollars arising from investment considerations, relative to the strength of excess supply of dollars related to the current-account deficit. By assumption, excess demand for dollars arising from investment considerations is unchanged by

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2. In this case, the outcome in relative terms is less clear; even though the drop in foreign real GNP is likely to be larger than the drop in U.S. real GNP, the percentage decline in U.S. real GNP could exceed the percentage decline in foreign real GNP.

the surcharge. Because the surcharge improves the trade balance at a constant exchange rate, excess supply of dollars related to the current-account deficit declines at the initial exchange rate. Thus, demand exceeds supply, and the dollar must appreciate in order to equilibrate the exchange markets.

One of the motivations underlying proposals for an import surcharge is to ameliorate the effects of what many observers consider to be an overvalued dollar. But if net capital inflows remain strong, it follows that such an import surcharge would be partially self-defeating. Although the relative position of U.S. import-competing industries would still probably improve, exporters would be in worse straits than before, because: (1) the dollar would be stronger; (2) foreign real incomes would be lower; and (3) the U.S. price level would be higher. In fact, a good deal of the favorable impact of a surcharge on the U.S. trade balance could be offset by ensuing dollar appreciation and lower foreign income.

It is very unlikely that this basic result would be altered by allowing autonomous capital flows to change in response to the import surcharge. It has already been noted that the deterioration of foreign incomes would make the United States a relatively attractive place for investment. In addition, a tariff, thought to be permanent, would induce foreigners to establish U.S. plants in an effort to leap over the tariff barrier. While such investments could be financed in U.S. capital markets, it is more likely that some funds would be brought in from abroad. Thus, while it is possible to concoct circumstances in which the tariff might inspire U.S. capital outflow, 3/ an enhanced capital inflow seems much more likely. This would add to the appreciation of the dollar, causing the surcharge-induced improvement in the trade balance to be reduced further; indeed, it is possible to imagine cases in which the autonomous inflow of capital increases significantly and, at least temporarily, leaves the trade balance worse off than before the surcharge.

The strength of foreign feedback effects suggests that even though domestic expenditure switching might otherwise offset contractionary fiscal-policy effects on the domestic economy, an import surcharge could lower U.S. real GNP indirectly through its effects on the rest of the world. The base-case scenario might require stimulative monetary policy to achieve the outcome of no change in domestic aggregate demand and no change in U.S. real GNP. If so, it is additionally assumed that all domestic prices increase proportionately in response to the monetary stimulus, so that relative price movements are dictated solely by the import surcharge.

U.S. imports tend to be capital intensive, whereas U.S. exports tend to be labor intensive. More specifically, U.S. exports tend to be skilled-labor intensive. In the base case, an import surcharge results in the transfer of

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3. Some U.S. producers who are highly dependent on imports as inputs might be inspired to move their facilities abroad in order to avoid the higher costs imposed by the tariff, but this impact would be unlikely to dominate.

real resources from U.S. industries characterized by comparative cost advantages to less-efficient import-competing U.S. industries characterized by comparative cost disadvantages. Thus, the wage rate of skilled labor falls relative to the wage rate of unskilled labor, and relative to the rental price of capital. The loss of economic efficiency resulting from a suboptimal allocation of domestic resources is mitigated to the extent that capital movements substitute for trade, because net capital inflows alleviate the relative domestic scarcity of capital. Nonetheless, capital inflows cannot eliminate the loss of economic efficiency as long as distortions exist between internal and external relative prices.

Under the base-case assumptions that there is no retaliation and no change in aggregate demand, the main impact of an import surcharge would be on the composition of production and final demand. As stated earlier, some industries, particularly those that compete with imports, would gain as a result of the protective tariff. But others would lose because they rely on foreign inputs, and, therefore, would experience higher production costs. Consumers, of course, would also lose, from higher costs of both imported and domestic products.

Identifying those industries that would expand or contract in response to a surcharge is (under the base-case assumptions) essentially a matter of identifying the effects of higher import prices as the tariff is passed through, and as buyers rearrange their purchases. Higher import prices will generally induce domestic purchasers to substitute like domestic goods for imported ones, where they can, or to switch to other goods where possible. At the same time, where substitution is not possible, purchasers will simply have to pay the higher cost, either through drawing on savings (discussed in Section IV, below) or through eliminating other purchases.

Winning and losing industries can be identified with the aid of input-output analysis, which allows one to trace the effects of changes in the prices of imported goods and their domestic substitutes through the economy--both in terms of inputs to final products and of outputs of final products themselves. This type of analysis would show how the composition of domestic output and consumption is likely to be affected by the imposition of a surcharge. Without that analysis, it is not obvious which industries would be the winners and which the losers. Certainly, domestic mineral producers would benefit from the higher prices of foreign competitors, but users of those minerals would face higher costs and would thus be injured. The next phase of this study will attempt to identify the winning and losing sectors of the economy with more precision.

Although the base case assumes no foreign retaliation, which precludes any major direct negative effect on U.S. exports, some negative effects could be expected as U.S. producers, including producers of export goods, faced higher production costs. Should other countries choose to retaliate against the United States in kind, domestic compositional effects could be even more pronounced as some key exporting industries, such as agriculture and aircraft, would have to bear the brunt of reduced foreign demand for their products.

SECTION IV: IMPLICATIONS OF MAKING THE TARIFF TRULY TEMPORARY

The foregoing analysis has assumed that private economic agents expect a U.S. import surcharge to be permanent. The rationale underlying this assumption has its roots in experience; protectionist measures that are instituted on a temporary basis often have a way of becoming rather long-lived, if not permanent. A number of conclusions could change considerably, however, if people making economic decisions believed that a U.S. import surcharge would be only temporary.

One possibility is that U.S. citizens might not change their consumption behavior at all, but would absorb the full impact of the temporary surcharge by dipping into their savings. If real expenditures on imports did not decline, there would be no expenditure-switching effect. There would be no direct contractionary fiscal-policy effect either, because the temporary decline in private savings would fully counteract the loss in purchasing power from the withdrawal of tariff revenues from the domestic expenditure stream.

On the other hand, because temporary depletion of savings implies little or no change in spending on imports, a surcharge will reduce the federal deficit more since tariff revenues remain at a high level as long as the import surcharge stays in place. The greater reduction in the federal deficit, which is not expected to be permanent, is unlikely to have any significant effect on real interest rates, however, because it will be exactly offset by a fall in private saving. Prices will rise to the consumer by an amount equal to the surcharge. Moreover, given that there is no change in import spending behavior, the external deficit will not improve.

This is not the only possible outcome, of course, because not all U.S. citizens may be willing to sustain higher spending on imports. Although many may want to maintain their import spending in real terms on a temporary basis, including manufacturers who use imported inputs in their production processes, many others may simply postpone purchases from abroad.

To take an extreme example, if the majority of importers postpone their import purchases until the surcharge is lifted, and if simultaneously U.S. citizens conclude that American goods are unacceptable substitutes for import goods, a number of conclusions change dramatically. The U.S. trade balance and current account balance improve sharply. There is no expenditure-switching effect because of the unacceptability of American substitutes, but there is no direct contractionary fiscal-policy effect either because postponed import spending yields no tariff revenues. Nonetheless, the rise in the private-saving ratio lowers domestic interest rates somewhat, and this indirectly raises U.S. real GNP. As a result, there is some improvement in the federal deficit.

In the latter case, the impact on U.S. real GNP is positive, though possibly not large. This suggests the possibility that U.S. net capital inflows might be stimulated. Other forces, however, work to further confuse the issue. If private markets expect a U.S. import surcharge to be truly temporary, foreigners who might engage in direct investment in the United States would know that there would be no permanent tariff wall to protect U.S. markets in the future. Thus, they would have no incentive to accelerate the pace of their investing in U.S. facilities. In this event, a surcharge-induced increase in capital inflows would be much less likely, and the dollar would appreciate less or possibly even decline.

SECTION V. IMPLICATIONS OF RETALIATION

If an import surcharge was perceived as being relatively permanent or if U.S. citizens were to postpone their import expenditures on a grand scale, qualitative analysis indicates that a U.S. import surcharge would reduce foreign real GNP significantly. In fact, even in cases where U.S. real GNP declines, the decline in foreign real GNP would likely be even greater. The major trading partners of the United States could respond with more stimulative monetary and fiscal policies of their own, but a more direct and a more probable response would be to raise their own tariff or nontariff barriers to U.S. exports.

History demonstrates the plausibility of a retaliatory tariff scenario. When the United States passed the Smoot-Hawley Tariff Act of 1930, many foreign countries imposed substantial tariffs of their own. Smoot-Hawley raised tariff levels on dutiable imported goods to an average level of 53 percent in 1932, an increase of 33 percent over 1929 levels. Retaliation led to a downward spiral in international trade--U.S. exports fell from 5 percent of GNP in 1929 to 2.8 percent in 1932. In fact, collected duties fell by over 50 percent between 1929 and 1932, as both the volume and value of imports declined.

In the postwar period, a 10 percent ad valorem surcharge was imposed in 1971 as part of President Nixon's "New Economic Policy"--a multifaceted attempt to improve the foreign trade position of the United States. (It included, among other things, abandoning the fixed exchange-rate system and imposing wage and price controls.) The surcharge covered all dutiable imports and was used primarily as a bargaining chip to induce other countries to revalue their currencies. With some exceptions, the effective rate of the surcharge was about 4.8 percent. Foreign reaction to the surcharge was hostile, but the legal situation was ambiguous. A working party of the General Agreement on Tariffs and Trade (GATT) found that the surcharge was in line with the magnitude of the U.S. trade deficit problem, but was inappropriate under the GATT. The working party urged the United States to remove the surcharge within "a short time," but stopped short of calling for sanctions. It was removed within four months of its promulgation, after the Smithsonian Agreement of 1971, and any threats of retaliation evaporated.

Although the likelihood of foreign retaliation against an import surcharge is high, experience shows that its type and extent are virtually impossible to predict. One may assume that the retaliating country or bloc of countries would raise its own trade barriers to U.S. exports by an amount that would result in a percentage reduction of U.S. exports equal to the percentage reduction in its own exports. Given this or other similarly arbitrary rules of behavior, the mechanics of a retaliatory commercial policy scenario would be relatively simple to handle--if one ignored the effects on capital flows.

If exchange rates are held constant, which is a reasonable approximation in this case, a qualitative analysis suggests that, at each step of the retaliatory process, a country or world region raising its trade barriers may either raise or lower its own real GNP somewhat, but the reduction in foreign real GNP is likely to be greater. Consequently, depending on how many retaliatory rounds are allowed, the reduction in world trade and world real GNP may be substantial. If retaliation accumulates and gets out of hand, there is a danger of serious worldwide economic decline.

Unfortunately, when capital flows are considered, the direction of exchange-rate movements in a retaliatory commercial policy scenario becomes extremely difficult to predict. Capital flows could go either way, depending on expectations of the final outcome of the retaliatory process. Moreover, in such a belligerent atmosphere, it is quite likely that capital flows would be made subject to punitive taxation.

It is possible, then, that a confluence of capital controls, taxes on international flows of investment income, and universally heightened risk could result in a substantial reduction in the volume of international capital flows. In this event, U.S. interest rates could rise significantly, output and incomes would fall, and the federal debt could explode. High dollar interest rates and a contraction of world trade could result in acute financial problems for Third World debtors and for their U.S. creditors, mostly banks unable to collect their loans.

ATTACHMENT B. A REVIEW OF THE DRI IMPORT SURCHARGE STUDY

This report examines the likely robustness of a recent study by Data Resources, Inc. (DRI) of the macroeconomic impacts of a temporary uniform tariff increase. 1/ The DRI results suggest that if social planners are prepared to incur modest near-term costs implied by depressed activity over the duration of the surcharge, longer-run benefits in the form of a permanently lower debt/output ratio, and generally higher real activity, may be possible. Furthermore, DRI argues, "(in) comparison with other deficit-reduction efforts that also have an impact on inflation,..., a tariff looks relatively good because it shifts some of the burden of closing the deficit to foreigners." 2/

As with all model-based policy assessments, certain assumptions were made by DRI regarding the nature of the policy itself. The DRI study is very clear about these assumptions. Because the study reports simulation results for only one set of conditioning assumptions, however, it leaves open the question of robustness; that is, how likely is the adoption of an alternative set of conditioning factors to lead to alternative sets of point estimates that cast the policy's impact in a radically different light? This is the central question. To address this issue, CBO first discusses the DRI

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1. C. Caton, "The Effects of a Temporary Import Tariff," DRI Review of the U.S. Economy (March 1985) pp. 13-20.

2. Ibid., p. 20. Emphasis is DRI's.

results and delineate the enabling assumptions employed. This discussion appears in the first section below. In the second section on Elements of the DRI Model Structure, some relevant characteristics of the DRI model are examined as a check for potential biases in the model's parameterization. Since no systematic biases are identified, and since this second section is rather technical, the reader can skip that section without any loss in continuity. In the third section, the likely effects of changes in assumptions are explored. A final section summarizes CBO's conclusions.

One point is critical to note at the outset. The quantitative elements of the following discussion derive solely from the study itself, published DRI model documentation, and a methodological briefing by DRI staff members held in early March. Sensitivity tests of the DRI experiment are beyond the scope of the present endeavor. Thus, the discussion does not reflect any simulation results undertaken by CBO. The limitations implied by this fact are clear.

THE DRI RESULTS

The DRI study examines the impacts of a three-year phased-out surcharge on all imported goods. The temporary surtax is assumed to begin in 1986 with a 20 percent increase in tariff rates, followed by a 15 percent levy in 1987 and 7 percent in 1988. The policy change is introduced into a "no policy" baseline environment. DRI constructs this baseline by removing from their standard (control) forecast any federal policy changes they may be forecasting. In essence, the "no policy" baseline is DRI's analogue to the current service projection of OMB or to CBO's baseline economic projection. The baseline forecast shows real interest rates, exchange rates, and federal deficits to be relatively high by historical standards. 3/ This is not to say that the forecast is remarkably different from the current consensus (which it clearly is not) but only to emphasize that these "initial conditions" are important. To the extent that large deficits and "cautious monetary policy" lead to high interest rates (as the study states), the relative movements in economic variables induced by a new fiscal-monetary policy mix will not typically be independent of the initial conditions.

The simulation work proceeds on the basis of four assumptions:

(1) The surcharge is applied to all imported goods without exemption (uniformity);

(2) Foreign producers "absorb" 50 percent of the surcharge in the form of reduced supply prices;

(3) No foreign retaliation takes place;

(4) The domestic monetary authority responds to the policy with an initial (passive) accommodation and a subsequent (active) expansion in the money supply.

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3. Ibid., pp. 14-16.

The initial effects of the surtax include an increase in the price level (via direct increases in the price of imported goods for final use and in the costs of production for domestic producers using imported inputs), along with a reduction in the federal deficit (increased customs revenues), and an improvement in the current account (increased import prices discouraging import demand, in conjunction with lower external prices for imports). The induced decline in real income leads to a 0.4 percent decline in total real demand. Reduced imports offset about half of this, so that real GNP declines by 0.2 percent in the first year. 4/

A major advantage of using an econometric model for policy analysis is that, when appropriately specified, the model can account for complicated feedback influences throughout the economy. In the present context, these influences are significant. For example, while income-induced declines in real consumption (-0.6 percent) dominate the first-year fall in real GNP (-0.2 percent), the decline in overall activity begins to inhibit investment spending by the second year. Export activity is also reduced by the second year, the result of a decline in foreign real activity as well as a dollar appreciation consistent with improvement in the current account (current account improvement, ceteris paribus, implies a relative increase in the demand for dollar-denominated assets). Thus, even though

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4. In the next section, the direct links between the tariff and the macroeconomy in the DRI model will be discussed in greater detail.

the surcharge is phased out after the first year, the adverse consequences for domestic activity linger on, with most of the indicators reported by DRI showing their largest declines in 1988, the final year of the surcharge. In that year, DRI finds real GNP to be down 1.1 percent relative to its baseline level, and the unemployment rate is at its relative maximum, up 0.4 points from baseline--all of which represent relatively small movements.

Once the surcharge is removed, however, this prognosis is decidedly reversed. To quote from the study:

> "In the years 1989-92, the legacy of the tariff persists. Both inflation and the size of the public debt are reduced. As a result, short-term rates begin to come down, the exchange rate depreciates relative to the baseline, and real activity begins to move back towards the baseline." 5/

Indeed, by 1992, the simulation results indicate the policy has achieved a cumulative federal deficit reduction of $210 billion; a cumulative improvement in the current account balance of $156 billion; declines in real interest rates, the price level, and unemployment; and increased real activity relative to baseline.

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5. Ibid., p. 18.

ELEMENTS OF THE DRI MODEL STRUCTURE

Does the specification and parameterization of the DRI model impart any biases to the range of possible simulation outcomes? In addressing this issue, CBO has examined the two sectors of the model most relevant to the analysis of tariff policy: foreign trade and the price level. 6/

Merchandise Trade Flows

DRI distinguishes seven categories of merchandise imports and six categories of exported goods. The classifications are by end-use, and the data underlying the estimated equations are the 1967 benchmark Census series (Series 990). The model calculates real demands and prices using behavioral specifications so that nominal flows are determined by indentities. Service flows are included in the model but are not discussed here.

The real flow demands follow a fairly common specification with the exception of fuel imports, which are discussed below. The typical import

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6. The overall structure of the DRI model is examined in great detail in Otto Eckstein, The DRI Model of the U.S. Economy (McGraw Hill, 1983). The version of the model used in the surcharge study is described in Otto Eckstein et al., "Properties of the 1983-A Version of the DRI Macro Model," DRI Review of the U.S. Economy (April 1983), pp. 1.13-1.18. As of this writing, DRI is preparing to release an updated version of their model. Therefore, many of the specific points made here regarding the model's properties may not apply to the new version.

specification relates real import demand to a real domestic final demand term and a relative price term (import price relative to the domestic wholesale price of the competing good). A typical real export equation relates the real flow to a weighted average of measures of real foreign economic activity (production measures, to be described below) and a relative price term (the dollar price of the exported good relative to the converted world wholesale price level). All equations are of the constant elasticity variety, and the right-hand side variables are all entered as distributed lags of varying length.

Table 1 contains a listing of the trade flow elasticities with respect to real activity and price. For each end-use category (excluding fuel imports), the table lists elasticities and lag lengths (in quarters). Note that for several import categories, income elasticities are unitary. In each of these cases, this is the result of a coefficent restriction imposed a priori.

In the case of automotive imports, the specification is atypical since price terms are not present (presumably because of the existence of quantity rationing), and the demand elasticity is restricted to be unitary. To estimate an equation for auto imports, DRI regresses real auto imports relative to real domestic auto consumption against a cyclical variable--consumer sentiment. An elasticity of -0.5 is obtained.

TABLE 1. REAL MERCHANDISE TRADE FLOW ELASTICITIES

	Real Activity			Price			1983 [a]
End-Use Category	Short run	Long run	Lag Length	Short run	Long run	Lag Length	Share (%)
Imports							
Food	0.519	1.298	4	-0.048	-0.447	6	9.1
Materials (nonfuel)	0.558	1.394	4	-0.101	-0.946	6	22.0
Capital goods	1.000	1.000	0	-0.121	-0.302	4	22.6
Automotive	1.000	1.000	0	-	-	-	13.3
Consumer goods	1.000	1.000	0	-0.078	-0.731	6	22.8
Other goods	0.514	1.284	4	-0.137	-1.280	6	3.1
Exports							
Food	0.233	0.581	4	-0.111	-0.554	4	11.1
Materials (nonfuel)	0.330	0.824	4	-0.050	-0.469	6	28.3
Capital goods	0.532	1.330	4	-0.119	-1.107	6	28.8
Automotive	0.468	1.171	4	-0.079	-0.736	6	7.0
Consumer goods	0.397	0.992	4	-0.206	-1.636	6	9.0
Other goods	0.370	0.925	4	-0.074	-0.692	6	7.9

SOURCE: Congressional Budget Office calculations based on data from Data Resources, Inc., Macro Model of the U.S. Economy: Version US83A Equation (March 1983).

[a] Percentage distribution of merchandise trade flows across end-use types. Fuel imports have been excluded from the detail but not the total.

The import and export unit value indices--free alongside ship (f.a.s.) and, hence, pre-tariff)--are also endogenously forecast in the DRI model. The typical import price equation relates the rate of change in the unit value index to a distributed lag on the rate of change of the converted foreign producer price. (Again, the specifications are of the constant elasticity variety.) The foreign price level employed in the right-hand side is the same across end-use import types. In the case of exports, the sectoral specifications are consistent with a constant mark-up pricing scheme by domestic exporters. Specifically, the rate of change in an export unit value index is regressed against a distributed lag on the rate of change in the domestic producer price for the same type of good.

For reference purposes, Table 2 displays the estimated inflation elasticities. In some instances, these elasticities are only partial elasticities, since in several cases DRI adds cyclical variables (for example, vendor performance) that are price sensitive.

Regarding fuel imports, the model's structure is somewhat different. Real fuel import demand (1967 dollars) is related to a physical measure of energy imports (BTUs). This physical measure of energy imports is, in turn, related to both real activity and the price of imported oil, although in a complicated way. The foreign oil price in the DRI model is represented by an acquisition cost concept (post-tariff).

TABLE 2. IMPORT PRICE INFLATION ELASTICITIES

End-Use Category	Short run	Long run	Lag Length (Quarters)
Imports			
Food	0.496	0.992	2
Materials (nonfuel)	0.457	0.913	2
Capital goods	0.295	0.998	2
Automotive	0.450	0.997	3
Consumer goods	0.269	0.997	3
Exports			
Food	0.685	1.027	1
Materials (nonfuel)	0.539	1.079	2
Capital goods	0.008	0.985	3
Automotive	0.485	0.970	2
Consumer goods	0.061	1.098	2

SOURCE: Congressional Budget Office calculations based on data from Data Resources, Inc., Macro Model of the U.S. Economy: Version US83A Equation (March 1983).

The determination of merchandise trade flows is completed by the specification of equations for the foreign economic indicators (foreign producer price index and real production indices for Canada, Japan, and OECD Europe) and the exchange rate. The rate of change in each of the foreign economic indicators is regressed against relative movements in analogous indicators for the United States. In the case of the foreign producer price, a weighted average of various domestic producer prices is used as the domestic analogue. These specifications seem designed to capture the importance of the United States in world trade to the extent that cyclical variations in the domestic economy will be transmitted abroad.

The DRI exchange rate is a trade-weighted index (May 1970 = 1.0) published by Morgan Guaranty Trust. The exchange rate equation represents an attempt to incorporate both current and capital account influences. Full stock/flow interactions are not present, however. The current account influences are introduced by relating the relative change in the exchange rate to the oil-adjusted nominal trade balance relative to GNP (assuming 50 percent of fuel import transactions are dollar-denominated) over the preceding four quarters. Capital account influences are accommodated by a partial interest-parity mechanism in which both the change and level of the 90-day Treasury bill rate are included as determinants of movement in the U.S. dollar rate. Since interest-parity relies on international capital flows to equilibrate (risk-adjusted) international interest-rate differentials, and since foreign interest rates are not present in the DRI model, the parity mechanism is only partially specified. As with the foreign economic indicators mentioned earlier, some appeal must be made to the size of the U.S. position in world transactions in order to justify this specification.

With this outline of the DRI trade sector in mind, the immediate impacts of the surcharge are easily traced out. The surcharge raises import unit value indices by the effective rate of tariff increase (that is, the surcharge rate times one minus the absorption rate), resulting in a direct decline in real import demand. To the extent that real incomes are reduced, several of the income proxies also decline resulting in further declines in import demand. Since, in the DRI study, interest rates move up only marginally owing to the price-induced increase in money demand, current account influences dominate in the near term, placing upward pressure on the exchange rate. Foreign production activity reacts to depressed U.S. production with a lag so that the combined impact of dollar appreciation and declining demand overseas lowers U.S. exports in a delayed fashion. Real exports show significant decline (-1.7 percent) by the second year of the surcharge.

Does this specification of trade flows significantly bias the results? It is possible to question a number of the DRI specifications (as it is possible to do in virtually every model). For example, it was noted above that many of the income elasticities of import demand are constrained to unity. In a recent survey of empirical literature, Goldstein and Khan report that all but one of the studies surveyed indicate long-run income elasticities of total U.S. import demand well in excess of the (nonfuel) average of 1.06 implied in Table 1. 7/ This implies that the DRI specification may have underestimated the import decline. Moreover, the specification of foreign real activity may equally well have understated the declines in foreign production activity since they rely only on the transmission of income effects from the U.S. The assumption of foreign absorption, in particular, may imply declines in these foreign variables beyond what the model

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7. M. Goldstein and M.S. Khan, "Income and Price Effects in Foreign Trade," Chapter 20 in R.W. Jones and P.B. Kenen, Handbook of International Economics, vol. 2 (North-Holland, 1985).

specifications would indicate. (Movements in relative prices that apply to U.S. trade could also affect foreign real activity through other channels.) If this were the case, it could be argued that the model may also have underestimated the depressing effects of the surcharge on U.S. exports. Any bias in the current account balance is thus indeterminate without further empirical investigation.

Determination of the Price Level

Price determination in the DRI model is influenced by a combination of cost-push and demand-pull factors. Since the cost-push elements are of primary relevance in the present context, demand-side influences can be dealt with very briefly. Two related but distinct demand measures used in the DRI price equations are the unemployment rate and alternative indicators of slack demand (either the Federal Reserve Board capacity utilization measure or delivery lags). The unemployment rate--determined by a variant of Okun's Law--enters the wage rate equation with a Phillips curve structure. Prices, in general, can be viewed as a variable mark-up over expected unit costs, with the mark-up factor a function of the slackness of demand. Although demand-side influences will be important, the direct price effect of the surcharge will be dominated by passthrough on the cost side.

The unit value indices for imports--described earlier--affect prices via two routes. First, several of these prices enter the wholesale price block (primarily import prices for materials, capital goods, and fuel). Second, some of the import value indices enter the equations for several final demand deflators directly (for example, automotive consumption and equipment investment). In almost every instance, import prices enter as one element in an aggregate materials term with a factor usage weight applied to the various import prices. In the wholesale price block, these weights derive from an input/output (I/O) structure, while in the case of final demand deflators, individual import prices may be weighted by demand mix terms. In addition, the material cost terms are entered on the right-hand side of the respective price equations with a distributed lag.

Generally, the producer price mark-up structure implies a production structure with substitution (at constant rates) between aggregate material and labor inputs and allocations among the disaggregate material inputs (including imported goods) following a fixed proportions framework. This separability assumption implied for the sectoral production technology is consistent with the following two-stage allocation sequence. On the first round, producers allocate labor and total materials using a constant elasticity technology. Once total materials usage has been determined, a second round allocation is made, whereby total demand for materials is distributed across detailed material inputs according to a fixed proportions rule (that is, an I/O table column).

Thus, the passthrough of an import price shock to the overall price level depends on the following:

(a) The direct impacts on producer prices (and selected deflators);

(b) The ultimate passthrough from producer prices to the overall price level including indirect cost and demand effects.

An examination of the model's equation coefficients is instructive only in discussing (a). The effect in (b) is obviously dependent on model simulation (as well as equation) properties and will not be discussed further here.

Given the above discussion, it should be clear that the direct determinants of import price passthrough will depend on both the elasticity of price with respect to material costs as well as the I/O weight on the relevant import category used in the calculation of aggregate sectoral materials demand. These parameters are displayed in Table 3. In interpreting the parameter estimates in Table 3, several points are worth emphasizing. First, the estimates are helpful only in comparing the relative direct impacts of changes in import prices. The reason is, of course, that the I/O cross-equation links are more pervasive than a single equation specification would imply since the single equation delineates only direct effects. Second, in several instances input prices enter into the producer price equations separately and without weights (for example, metals). In the context

TABLE 3. DIRECT MATERIAL COST INFLATION PASSTHROUGH ELASTICITIES

	Short Run	Long Run	Lag Length	I/O Import Weight
Food, Feeds, and Beverage Imports				
WPI, Processed Food	0.807	1.211	1	0.049
Nonfuel Material Imports				
WPI, Textiles & Apparel	0.418	0.627	1	0.026
WPI, Chemicals	0.272	1.253	2	0.039
WPI, Rubber & Plastics	0.561	0.841	1	0.051
WPI, Lumber & Wood	0.408	0.816	2	0.091
WPI, Pulp & Paper	0.742	1.113	1	0.065
WPI, Metals	0.094	0.161	1	--
WPI, Misc. Industrial	0.658	0.986	1	0.012
Capital Goods Imports:				
WPI, Machinery & Equipment a/	0.011	0.011	1	--
IPD, Investment, PDE	0.350	0.893	3	b/
Automotive Imports:				
IPD, Consumption, Auto.	0.004	0.004	0	--
Consumer Goods Imports:				
WPI, Textiles & Apparel	0.418	0.627	1	0.055
WPI, Rubber & Plastics	0.561	0.841	1	0.023
WPI, Miscellaneous Industrial	0.658	0.986	1	0.095
IPD, Consumption, Clothing	0.013	0.371	2	0.093
IPD, Consumption, Furniture	0.440	1.039	3	0.031
IPD, Consumption, Other Durables	0.256	0.508	2	0.074

SOURCE: Congressional Budget Office calculations based on data from Data Resources, Inc., Macro Model of the U.S. Economy: Version US83A Equation (March 1983).

NOTES:
I/O = input/output.
WPI = wholesale price index.
IPD = implicit price deflator.
PDE = producers' durable equipment.

a. Only lagged price effect included.
b. Import share of PDE investment is used as a weight.

of the structural framework described above, this type of specification would yield (lower) parameter estimates reflecting the fact that the regression equation is now picking up (and is dominated by) the I/O weight as well as the generic materials effect.

The producer price block has familiar Cobb-Douglass theoretical structure. Unfortunately, given the stated theoretical foundation for this sector, it is impossible to obtain reasonable parameter estimates without the imposition (if not the testing) of parameter restrictions. That such restrictions were not imposed by DRI is evident from the uniformly high long-run elasticities in Table 3 (in the long run, these elasticities should equal the materials share). Thus, while these producer price equations may have good forecasting properties, the passthrough implications appear to be unreasonably large.

Conclusions based on this observation may be hasty. One reason to suspect that the aforementioned upward bias may not be the whole story is that the I/O weights used by DRI in constructing the aggregate materials cost terms are dated. Benchmark I/O tables are published by the Bureau of Economic Analysis (BEA) only in economic census years (every five years). Although it is possible to "update" I/O tables to any year for which a comprehensive set of industry data is available, the derived coefficients are often inextricably linked to the benchmark data. The DRI I/O weights are based on a 1977 update of the 1972 BEA benchmark I/O tables (the most recent data available to DRI at the time this version of the macro model was compiled). The secular movement of import intensities in final use since 1972 (and 1977) has been unambiguously upward. Thus, the dated I/O weights in the DRI price equations are likely to understate the import content of aggregate materials demand by U.S. industries. This observation together with that made above regarding the materials cost coefficients lead, once again, to the conclusion that the direction of overall bias in this sector is indeterminate.

Thus, the two key sectors of the DRI model do not seem to manifest clear and predictable biases, at least based on this cursory review, that may lead to the "forcing" of a particular range of macroeconomic results. While it is important to point out that no standard model can be expected to be perfectly suited for every conceivable policy application, it is no less important, in evaluating policy experiements performed in such models, to examine the conditional hypothesis imposed by the model itself. In the present context, then, it is appropriate that attention be diverted toward the several other conditioning hypotheses maintained in the DRI study.

THE ROLE OF CONDITIONING FACTORS

While the DRI assumptions are not necessarily implausible, it is important to understand how sensitive the reported DRI results are to changes in these assumptions. The purpose of this section is to further qualify the DRI results. As demonstrated below, changing the policy itself to a flat rate of

20 percent (that is, no phase-out) and relaxing assumptions (1) through (4) would almost certainly increase the short-run costs of the policy. In addition, CBO's analysis suggests that the long-run economic prospects are dramatically influenced by the assumption of an active expansion of the money supply by the Federal Reserve. Thus, under a no-less-plausible set of assumptions, the DRI model could easily produce simulation results that are counter to those reported by DRI: more costly adverse effects in the near-term as well as a much less rapid return to growth in the long run, at the very least.

Sensitivity of the Short-Run Results

As briefly described in the first section and documented more fully in the DRI study, the initial adverse effects of the phased out surcharge are the induced real income loss and an associated decline in consumption expenditure that more than offsets the decline in import demands. Even as the surcharge rate is reduced, the initial decline in real output leads to reduced activity in sectors that are only indirectly linked to real disposable income (for example, business fixed investment). The first point to be made is an obvious one. That is, if the surcharge were assumed to be imposed at a flat rate of 20 percent (without changing any of the other assumptions), the short-run declines would be more dramatic. While the inflationary impact may still be diminished after the first year, this would be the result of larger induced declines in domestic demand and not on the phase-out rate of the import levy. The peak decline in real GNP would be larger and, based on the feedback lags implied in the DRI study, might occur well after the surcharge has been removed.

Several other qualifications are noted by DRI. 8/ The near-term declines reported by DRI would necessarily be larger if foreign retaliation were assumed, even though the upward pressure on exchange rates owing to the current account improvement might thus be eliminated. Suppose, for the sake of concreteness, retaliation is immediate and takes the form of import restrictions abroad on U.S.-produced goods that are sufficient to wipe out the U.S. current account gains entirely. Using data from the DRI study, this would imply (in a static sense) further declines in exports averaging $45 billion over 1986-1988, or an average additional decline (others things held equal) of $1.0 billion in nominal GNP. 9/ This direct loss would obviously instigate further losses as a result of feedback.

The appropriate qualifications of the analysis with regard to the assumed uniformity of the levy are noted by DRI. The effects of revising the assumptions, to incorporate nonuniform absorption and selective exemptions from the surtax are impossible to predict from a simple

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8. C. Caton, "The Effects of a Temporary Import Tariff," pp. 18-20.
9. Ibid., Table 3, p. 18.

examination of the DRI model equations since they would critically depend on simulated movements in relative prices. The results generated for the aggregate price level could go either way with respect to the DRI simulation. DRI does indicate the possibility of alternative outcomes if uniform exemptions are allowed. 10/

In summary, the short-term results obtained by DRI might be substantially altered if alternative assumptions about the tax phase out and retaliation are included. In addition to increasing the direct negative impacts of the tax, a joint relaxation of these assumptions is likely to produce more long-lasting adverse effects as a result of the nature of the feedback lags in the DRI model. These qualifications have, for the most part, been alluded to by DRI. The DRI study does, in fact, present an interesting rationalization of the absorption hypothesis.

Sensitivity of the Long-Run Results

As was mentioned earlier, the DRI results are relatively sanguine in the sense that the short-run adverse movements are modest and, in the long run, all the macro indicators reported show unambiguous improvement. In the fourth year after removal of the surcharge, real GNP is reported to have risen 1.0 percent above its baseline level.

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10. Ibid., p. 18.

It is impossible (without extending the DRI simulation to cover the years beyond 1992) to separate the permanent and transitory components of the recovery. 11/ DRI does provide a hint, however, in stating that although the current account improvement dissipates once the tax is removed, "the (federal) deficit is permanently improved because interest payments are lower." 12/Indeed, the improvement in activity by 1992 owes much to a 125 basis point decline (from baseline) in short-term interest rates and a 4.3 percent dollar depreciation. While real consumption expenditure in that year has only just re-achieved its baseline level, interest-sensitive sectors exhibit major gains, with real housing and business fixed investment up 6.5 percent and 1.4 percent, respectively. The effects of the dollar depreciation are evidenced by a 2.4 percent rise in real exports and a 1.7 percent decline in real import demand. Thus, it seems apparent that an explanation for the relatively large decline in interest rates and the substantial dollar depreciation (both of which show their largest absolute movements once the surcharge is removed) necessarily precedes an understanding of the favorable long-run picture painted in the DRI study.

11/ Transitory improvements might result from feedback lags that are symmetrical to those accounting for the delayed decline in aggregate activity when the tax is introduced.

12/ Ibid., p. 18.

The argument to be presented here is that the assumed monetary policy is in large part accountable for all these improvements. This conclusion is developed by the following sequence of arguments:

(1) The improvement in short-term rates is mostly the result of the assumed monetary policy;

(2) The dollar depreciation is implied by movements in interest rates and, by (1), is also profoundly influenced by monetary policy.

These arguments are now developed in turn. The DRI model equation for the 90-day Treasury bill rate (the key short-term rate in the model) is specified, generally, as positively related to nominal money demand and real activity, and inversely related to the availability of loanable funds (a variable directly linked to monetary instruments). Thus, the increases in activity would tend to increase the 90-day Treasury bill rate. DRI attributes the decline in rates to the decline in "inflation and the size of the public debt." 13/ The price level is very nearly at its baseline level in 1992, and the inflation rate is slightly higher. As for the role of the reduced deficit, the effects are mild. The interest rate equation is related to the public debt by incorporating (the logarithm of) the real per capita change in

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13. Ibid., p. 18.

U.S. government debt held by private investors. To illustrate the magnitudes involved, a $52 billion decline in gross federal debt (corresponding to the amount implied in the DRI study for 1992) was run through the interest rate equation with all other factors held constant. 14/ Using data for the fourth quarter of 1984 as a benchmark, this calculation yields a decline in the 90-day Treasury bill rate of 32 basis points, somewhat less than 30 percent of the decline reported by DRI. 15/ Noting that this decline would at least be partially offset by increased money demand and real activity, the conclusion that the expanded money supply accounted for a major share in the decline in interest rates is inevitable.

Evidence for the exchange rate dependence on the monetary policy is also present. As was mentioned in the section on Elements of the DRI Model Structure, the DRI exchange rate equation incorporates capital account influences by including the 90-day Treasury bill rate on the right-hand side. Because the 1992 DRI results show a current account improvement, the 4.3 percent depreciation of the dollar must be the result of the interest parity mechanism.

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14. That is, assuming money supply to be constant and also abstracting from the increased real activity that would lead to increases in this rate.

15. The use of a historical benchmark overstates the proportional decline in privately held debt leading to the possibility that the interest rate impact reported in the text is an upper bound on this partial effect.

Having made the case for arguments (1) and (2), it still must be shown that the movements in interest rates induced by monetary policy are effective in stimulating demand. While the composition of the long-run recovery shown in the DRI results alone attests to this, it is possible to show that the implied characteristics of the DRI model support this effect in general. In a 1983 test of the version of the model used in the study under review here, DRI shows that a sustained exogenous real shock to the model, accompanied by a monetary policy that keeps the supply of money at its baseline level, produces considerably different macro results than if monetary policy had been unchanged and the money supply had been allowed to fluctuate commensurate with demand. 16/ In their 1983 study, DRI finds the size of the real multiplier, after sixteen quarters of sustained shock with the money supply held at its baseline level, to range between 10 percent and 36 percent of the multiplier to be obtained if the Federal Reserve is assumed to play a passive role throughout and to allow the money supply to fluctuate endogenously.

These results are instructive in the present context. The DRI surcharge study assumes the Federal Reserve will react with a lag, allowing the money supply to grow endogenously with the increase in inflation early on. The Federal Reserve will expand supply only after the economy has

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16. Otto Eckstein et al., "Properties of the 1983-A Version of the DRI Macro Model," Table 3, p. 1.15.

shown weakness. The result is that the money supply rule is considerably more expansive than even DRI claims in terms of money growth. The money stock is nearest its baseline level in 1990 and exceeds the baseline value by a large 0.6 percent in the final year of the simulation. The extent to which the power of monetary policy in the model is considerable (as evidenced by the multiplier study) hints at the possibility that an alternative, less expansionary monetary policy could well nullify (if not more than offset) the long-run economic gains as both interest rates and the exchange rate would be unambiguously higher.

CONCLUSION

It is obviously desirable to buttress any qualitative policy assessment with quantitative analysis. A necessary precursor to any quantitative economic policy assessment is an economic model. Because no single model can ever be a complete characterization of the economic environment, a choice of models in practice involves the selection of a quantitative framework possessing sufficient flexibility to produce results of interest to the policymaker, along with the selection of several alternative hypotheses that the model incorporates as exogenous determinants. The quantitative results produced by simulating the model are conditional on the chosen exogenous factors. To be useful in the policy assessment, however, the model-based results must be robust in the sense that the influence of conditioning factors (about which the chosen model has little to say) is minimized.

Typically, a model is simulated many times, each time incorporating another of the alternative hypotheses. The collection of model results obtained in this fashion is then analyzed by evaluating the likelihood that each alternative hypothesis is true. The important point is that a quantitative assessment of any policy generated by only one set of conditioning factors is necessarily incomplete. The inevitable conclusion here is that the DRI study is incomplete in this sense. While it was argued in this review that the DRI model is not necessarily an inflexible tool for the purposes of analyzing surcharge policies, the results are likely to be extremely sensitive to the choice of conditioning factors. Perhaps the most predictable feature of the model is the important and pervasive influence of monetary policy. A no-less-plausible choice of a passive monetary response could dramatically change the nature of the long-run conclusion reached by DRI.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. No questions, Mr. Chairman.

The **Chairman**. I'm curious, Dr. Penner. If putting in a surcharge is going to cause the dollar to appreciate, wouldn't this only further encourage more exports to this country from other countries? Wouldn't it almost offset whatever effect we hope the surcharge would have?

Dr. **Penner**. We would not expect it to offset the effect of the surcharge completely. As we see it, first you shock the system with the tariff. That reduces the demand for foreign goods, and puts less dollars out into the world. That effect begins to appreciate the exchange rate. And as you suggest, it would offset part of the effects of the tariff in the first place. But under usual assumptions, it would not offset it completely. It would only be a partial offset.

The **Chairman**. So the drop in the trade would not be either—or the likelihood of the drop in the trade because of the surcharge would not be offset by the even higher appreciated dollar?

Dr. **Penner**. No, not completely. We would expect the trade balance to improve as a result of the whole exercise.

The **Chairman**. And the budget deficit to drop?

Dr. **Penner**. And the budget deficit to drop.

The **Chairman**. Tell me what you think the down sides are, then.

Dr. **Penner**. The main down side is that any tariff of this sort essentially means that you are moving resources from producing things that you do most efficiently toward things you do less efficiently. In other words, production in the United States would become somewhat less efficient on average and, at constant employments of labor and capital, would actually reduce our real GNP. So that is the basic efficiency cost of the tariff, if we just view it in isolation.

There would be adjustment costs as well. While the appreciation of the dollar that I spoke of would not totally offset the effects on the demand for imports, on the other hand it would reduce the demand for exports. So there are certain groups, mainly exporters in the economy, that would suffer. Of course, the tax would cause some pain to any industry that uses imports as an input to the production process. Presumably the surcharge would apply to oil, for example. Energy intensive industries would therefore be very hurt.

But all of those are, in essence, second order effects. I suppose the real fear is that the surcharge wouldn't just stop there—that other countries would respond with their own forms of protection. That is, of course, what happened in the early 1930's as a result of Smoot-Hawley. If that happened now, you would stimulate a downward cycle of continual losses in efficiency and probably contractionary forces as well.

The **Chairman**. That didn't happen, though, when Britain and Denmark and France and Canada put in import surcharges earlier in the last decade.

Dr. **Penner**. It doesn't happen every time. It also didn't happen, for example, when we put in the surcharge in the early 1970's. But in that case, the threats of retaliation became so severe that we quickly withdrew the surtax after a very short time.

Again, you can't say that it's a certainty. But it is one of those situations where the implications of the risk are so severe that it worries us a great deal.

The CHAIRMAN. You heard Mr. Galvin this morning?

Dr. PENNER. Just the last part of it.

The CHAIRMAN. He said roughly the same thing that the president of the Eastman Kodak Co. said yesterday. Both good companies. Both international competitors. Both are frankly admitting that given the present situation we are going to see some of our basic industries simply disappear. They are going to go overseas, and once they have made their capital investment, they are not going to come back.

Do you think their fears are well founded?

Dr. PENNER. I think that what we are doing to our economy is of grave concern. But I'm afraid the one thing that we seem to have a productive advantage of in this country is manufacturing bad policy. That is to say, we think the motivating cause for our difficulties is the budget deficit.

The CHAIRMAN. We even had an economist yesterday who said that wasn't true.

Dr. PENNER. Again, there is a lot of disagreement among economists. But we do believe that that the deficit has put pressure on domestic capital markets and stimulated domestic incomes. The pressure on domestic capital markets has attracted capital from abroad, as has the recovery here, and we believe that plays a very large role. It has played not only a role, mind you, but a very large role in the appreciation of the dollar and the difficulties of our trading industries.

The CHAIRMAN. I'll come back to that.

Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, just a few points.

Dr. Penner, in your summary statement you say the proposed import surcharge would actually raise the average tariff for all imported goods above the average level claimed by the Smoot-Hawley Act of 1930. I guess I'm behind the curve here. Which proposed surcharge?

Dr. PENNER. I was speaking of the 20-percent across-the-board surcharge?

Senator MOYNIHAN. Do we have a bill?

The CHAIRMAN. We have, as I recall, a discussion of 20–15–10. I don't know if we have a straight 20-percent bill before us. I can't remember.

Dr. PENNER. That statement referred to the 20-percent part of that.

Senator MOYNIHAN. Such as is being talked about?

Dr. PENNER. Yes.

Senator MOYNIHAN. You would have been interested, each of you, in yesterday's testimony. We had John Leddy here talking about the original understanding about exchange rates when the GATT was negotiated in 1946. And I think in our whole thinking about trade policy we, as time goes by, forget that the trade policies of the United States after World War II were fashioned in a context of the most awful global conflict the world had ever encountered. I mean you had Auschwitz at one end of the spectrum and Hiroshima on the other, and everything awful in between.

And it was a conviction of the men in the State Department at the time that much of that began with Smoot-Hawley. And that it was the beggar-thy-neighbor policies and the competitive devaluations and the unemployment and all of the 1930's of trade policy that led to world conflict; and brought on the regimes and brought on the policies that brought on the Second World War.

So they were dealing with something more than a marginal increase in GNP. And a slight easing off on the deflator. They were talking about world regimes. And I think we ought not to forget that such things can be at stake.

You say that we have a comparative advantage in the production of bad policy? Would you say this has been a historic development or is this a recent development? Has this been in place for a long time or for how many months?

Dr. PENNER. Perhaps "comparative advantage" was not the proper term since we do see a lot of bad policies all around the world. But I really do think that the adjustment difficulties that we have been experiencing are very closely related to the burgeoning of the Federal deficit. And I think the real tragedy of this is that the longer we go on with this policy, the more we are fitting our industrial structure around it. It is a policy in our view that, among the goods industries only defense is stimulated, although it does provide general stimulus to the service industries.

Senator MOYNIHAN. You are going to have to leave us, I guess. What you describe are the policies of the administration.

Dr. PENNER. Well, it has to be said they were voted for by the Congress. [Laughter.]

Senator MOYNIHAN. But who proposed them?

Dr. PENNER. The basic policy——

Senator MOYNIHAN. I want to note laughter off stage here.

Dr. PENNER. The basic policy stance emanated out of the deliberations of 1981 and appeared in the administration proposals at that time. Various things happened—it has to be said, on the administration's behalf—to alter the results of those policies from what the Administration expected. The most important thing that altered the results of those policies was the quick fall in inflation, which meant that the tax cuts were very much higher in real terms than most people had anticipated. The recession played a role as well.

SenatorMOYNIHAN. And the Federal Reserve played a role.

Dr. PENNER. And the Federal Reserve played a role in that, too, yes.

Senator MOYNIHAN. But it appears that the great innovation in our capacity to produce bad policy occurred in the early months of 1981.

Dr. PENNER. I'll leave that interpretation to you, sir.

Senator MOYNIHAN. Mr. Chairman, you know, we are not a partisan committee, you know that. [Laughter.]

We are simply a committee greedy for our parochial interests, which transcend any ideological divisions. [Laughter.]

The CHAIRMAN. My favorite one is that we like a complicated tax system because it gives us power to dole out the preferences. And that's why we don't want to get rid of it.

Senator MOYNIHAN. But there is a curious aspect to this; a certain kind of administrative enthusiasm to having presented us with absolutely ironclad propositions for an all but perfect future. When did mankind go wrong? The problem here is a set of very badly conceived proposals, which are so bad that most of the people involved in having conceived them can't conceive that they did. And this is a kind of amnesia quality.

But thank you very much, sir. And thank CBO for calling them as you see them. That's why you are there. And that's why we admire so much what you do.

Dr. PENNER. Thank you.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Dr. Penner, why would the surcharge cause a trade war? That's a conclusion that everybody arrives at. But why do you think that?

Dr. PENNER. The basic point is that a surcharge makes people very angry. I think Senator Moynihan alluded to that in his discussion of Smoot-Hawley. Whether one should blame Smoot-Hawley for World War II is quite another thing.

But there is absolutely no doubt that it raised international tensions enormously. People got very angry with us. And as part of their anger, even though you could argue that it was shooting themselves in their own foot, they did, in fact, respond by raising their own tariffs.

Senator BAUCUS. Smoot-Hawley as I recall it—I wasn't around but I read somewhere—had something like a thousand different protective measures by the time the bill was passed out of Congress.

Dr. PENNER. That is right because they went item by item.

Senator BAUCUS. Yes.

Dr. PENNER. It originally started out as a very mild sort of proposal dealing with agricultural products. But, again, the emotionalism of the debate just spread. And, as you say, it spread to a very large number of items.

On average, however, it was not as severe as this current proposal because Smoot-Hawley only applied to the dutiable items; that is to say, the things that already received protection, whereas this proposal would apply to every good in the system.

Senator BAUCUS. So you think that it's a high anger quotient that would lead countries to retaliate in kind.

Dr. PENNER. That isn't necessarily true. I don't want to put that forward as a certainty because, we simply don't know how other countries are going to respond. They could respond in other ways than through tariffs. They could respond in their defense policy. They could respond in all sorts of different ways.

So there is nothing certain about this business once you go down that route. But it is one of the things one has to consider as a risk. Even if you attached low probability to that risk, the implications of it occurring are so severe that even if it were a low probability risk, I think you would want to be very concerned about it before considering this kind of action.

Senator Baucus. What's a better alternative if the goal is to deal with the value of the U.S. dollar?

Dr. Penner. Again, we really believe that the current situation is linked to the fiscal situation. Therefore, the most direct response is to try and do something about the budget deficit to take the pressure off U.S. capital markets, which will, in turn, reduce the capital inflow, the value of the dollar, and improve the trade balance through that route.

Now, as the chairman said, some people disagree with that theory. There are people who think the budget deficit and the capital inflow are not related. Some people even think that if we reduce our budget deficit, foreigners will be so impressed with the wisdom and economic future of this country that money will absolutely pour in.

I don't think that is exactly what would happen. If it did, however, the one thing I could guarantee is that, as a result of both reducing the budget deficit and increasing foreign investment in this country, interest rates would plummet.

But our analysis is different than that. It is that the budget deficit is very important. It is not the sole cause, but a very important causal factor in this whole thing.

Senator Baucus. Do you believe the primary reason for the overvalued U.S. dollars is high U.S. real interest rates?

Dr. Penner. Yes, sir; I wouldn't even use the term "overvalued," because the value is what markets tell you it is. With those interest rates as the causal factor, I think it's hard to use that kind of term.

Senator Baucus. What value do you place on the assertion that the general increase of and the dollar being the major trade currency encourages people to buy dollars? Also what about speculation and the tremendous increase in the efficiency of capital markets? These factors in addition to high U.S. interest rates could have contributed to the high value of the U.S. dollar.

You don't seem to attribute much of value to those other factors.

Dr. Penner. I think there are all sorts of other factors that play a role—our recovery, the confidence in the political system of the United States, and so on. But I think the main thing that has changed since the early 1980's is the budget deficit.

Senator Baucus. I hope you are right. I just have a funny feeling that even if we get the budget deficit down $50 billion this year and perhaps next year that we are still going to have this problem. I don't think—I have a gut sense it's not that neat and simple. I hope that you are right. But I have a funny feeling it might not turn out quite that way. I hope you are right. I hope I'm wrong.

Thank you.

The **Chairman.** Senator Bentsen.

Senator Bentsen. Dr. Penner, in trying to get the deficit down, what's your reaction to a consumption tax?

Dr. Penner. I think the important point about any tax increase is that it should be broad based. That would mean it would have the least negative impact on the efficiency in the private sector. Many economists like the notion of a consumption tax from purely the viewpoint of—efficiency namely, that it would enhance savings and investment compared with a comprehensive income tax.

While it would probably have that effect, I think that the choice between a consumption tax and a total income tax, which also taxes the return to capital, is in very large part also a value judgment.

Senator **Bentsen**. Also a what?

Dr. **Penner**. A value judgment as to what you think is most fair.

Senator **Bentsen**. Obviously, you would have to structure a consumption tax in ways to try to make it fair and you can make it somewhat progressive.

Dr. **Penner**. That is right. You can make a consumption tax extremely progressive. Some people would still object to it under those circumstances.

The Brookings Institution has recently proposed an interesting variant. In their proposal, during your lifetime, you pay taxes on your consumption, but both inheritance and gifts are taxed very highly. So Brookings believes the plan will eventually affect all income.

I am only trying to say that there are some value judgments here as well. But from the point of view of economic efficiency, the most important thing is that, whether it is a consumption tax or an income tax, a tax be broad based, so that it doesn't distort choices.

A secondary point is that it shouldn't affect work effort that much overall and that you may wish to encourage investment by focusing on consumption rather than income.

Senator **Bentsen**. That was a very qualified answer.

Thank you very much.

The **Chairman**. Senator Heinz.

Senator **Heinz**. Mr. Chairman, I regret that I missed Dr. Penner's testimony. I have no questions.

The **Chairman**. In terms of priority, then, adopt the budget package or something like this first. Is that correct?

Dr. **Penner**. Some sort of deficit reduction, yes.

The **Chairman**. And when we early in this year had four economists testifying before us with reasonably different philosophies, they basically said the dollar is a dollar, is a dollar, is a dollar. If you make cuts within reason, it doesn't matter where you make them—you have got social reasons for making them one place or the other, but in terms of the economic effect, probably doesn't matter that much. Would you agree with that?

Dr. **Penner**. I would agree within reason. But one can think of spending cuts that would be very destructive to future economic efficiency—if we devastated our research community, for example. Or one can think of particular tax increases that would be devastating to economic efficiency.

The **Chairman**. Well, at the time we are talking about only spending cuts. And I think Charlie Schultz said, well, maybe a dollar is $0.95 to $1.05 but by and large didn't make much difference.

Dr. **Penner**. I think that is right. By far the most important judgment you are making is, again, an ideological one. What should the Government be responsible for and who should pay for it? That is the most important issue in the choice between the tax side and the spending side. But there are minor differences in economic efficiency effects of different approaches to that.

The **Chairman**. Should we be flirting with going back to fixed exchange rates or something akin to it?

Dr. **Penner**. I think that the tradeoff there is pretty clear. There is no doubt that the fluctuating exchange rate and especially its great volatility in recent months has caused problems. But if you make the choice to attack those problems by trying for a more rigid exchange rate, be absolutely clear that you are paying something very important for that. More specifically, you are accepting the obligation to constrain your domestic policies to achieve that exchange rate. Therefore, you may have to sacrifice efforts to direct your domestic policies of achieving a certain employment or inflation target. In other words, if you agree to maintain your exchange rate, you are giving up some of your sovereignty over your domestic goals. Now, a lot of people say that it is worth it. Other people would argue the contrary.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Yes; two things.

First, just for the record so as not to leave a mistaken impression of the general feelings among the people who put together our trade policies in the second World War. They did not think that Smoot-Hawley caused the Second World War.

Dr. **Penner**. There are a few who do. [Laughter.]

Senator **Moynihan**. But it was in that context of just unsuccessful bad trade policies, bad legislation, lack of executive control, the depression of that world in 1930 that hung on and hung on and hung on, and at the end you had that war. So a lot was involved in trade policy. More than just a certain time of economic efficiencies and comparative advantage.

Second, on the dollar, we heard two things. We've heard some really hard testimony. We were talked to yesterday about deindustrialization. And the Kodak Co. makes clear that a company of its kind will end up just as a marketing company here in the United States if the costs are such that they can produce overseas so much cheaper, can't sell overseas. He made the point that in 4 years, the price differential between Japanese film and American film in West Germany, the Federal Republic, that the Japanese film sells at 50 percent below the cost of the American product. They can't compete with that.

If you set out a situation in which the price of the dollar continues to rise, and I think it went up 2 percent yesterday.

Mr. **Santos**. Yes.

Senator **Moynihan**. At a certain point the problem of collapse introduces itself. And if you were to make a proposal where we have a policy where we are going to bring the value of the dollar down by 5 percent a year for 4 years, well anyone holding the dollar as a capital asset here would take them out immediately. And so it might go down 55 percent in the next afternoon. So that's a dilemma.

Exchange rates are something like Bretton Woods involves these costs. Giving up some sovereignty was one of the ideas of the American trade policy that was formulated during and after World War II. I mean it was that pure sovereignty that led you to 1934, 1935 and 1936.

Would you have any thoughts for us for this? We kept asking persons whose experience really had been in Treasury, in the executive, what to do yesterday and they basically said only Treasury and the Federal Reserve can tell you what to do. And in any event, "you in Congress can't do it."

Do you have any advice for us? You're our economist.

Dr. PENNER. I think it's a very difficult choice, Senator. I use the phrase "giving up sovereignty." Others would use the phrase that it would "impose discipline on policy," which is another way of saying you are giving up sovereignty.

I think there is one element of it, however, that we haven't discussed yet. And that is whether the horse is already out of the barn in the following sense.

One of the major reasons for going to a more fixed system, with the discipline that implies, is to give more people confidence over future inflation rates, stability of policies, and so on.

But the question that makes me very uneasy is wheher anybody would believe us now if we really promised to maintain the fixed value of the dollar vis-a-vis something else, gold or whatever. If they did, it would have profound effect on expectations. If they didn't you might have the worst of all possible worlds in which speculation would always go against you whenever you reached the limit that you had prescribed. At that point, you would have to make a decision. Are you willing, for example, to endure more domestic unemployment to attain a certain value of your currency with respect to something else?

I don't know whether I would really expect us to go through with our promise at that point or whether we wouldn't take what I think would be the easier course under those set of circumstances, and let the value of the exchange rate go. In that case, you haven't achieved the increased certainty by attempting to fix the rate.

So I think it is a terribly difficult choice. And in my own mind, I am really very unsure as to what the proper course should be.

Senator MOYNIHAN. That's why we are having hearings and not marking up a bill. But thank you very much.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Dr. Penner, what about the idea that this volatility is a new phenomenon and that after a while corporate treasurers, financial officers and governments are going to learn to live with it, and accept it, which will in turn lead to less volatility? I'm just trying to play a devil's advocate here and explore with you the possibility that maybe the extreme volatility won't continue much longer because people will adjust to this new system.

Is there anything to that?

Dr. PENNER. In very important ways, I think we have learned to live with it. Markets have developed over time through which you can hedge, so that in the short-run you can do those things fairly cheaply and gain certainty in a world of uncertain markets.

So I think sometimes the costs of this volatility are exaggerated. Some people would argue that it's a little more expensive to hedge and gain that certainty for the very long run—for the period of time, for example, over which it might be necessary to plan a whole change in your production procedures and move them from one country to another, and so on. But basically I think that the system that learns how to live with volatility fairly quickly.

Senator **BAUCUS**. What do you think about coordinated central bank intervention?

Dr. **PENNER**. Again, I think that has a very limited role ultimately.

Senator **BAUCUS**. Why so limited?

Dr. **PENNER**. There is so much private money out there compared with what central banks of the world can muster in this kind of speculation. And remember that in a sense what the central banks are doing is speculating with the taxpayers' money here.

And if things are fundamentally out of balance, that sort of sporadic intervention is very unlikely to be able to do anything about the problem in the long run. Ultimately, what you need is a change in the policies—the fundamental monetary policies most probably—of the countries involved.

Senator **BAUCUS**. What's your rough estimate of the ratio of private to public money? Take the five major countries.

Dr. **PENNER**. I don't have a number off the top of my head. But the amount of private money that moves around the world is really quite astounding.

Senator **BAUCUS**. Roughly how many times the public?

Dr. **PENNER**. Half a trillion is a number I got from a member of my staff.

Senator **BAUCUS**. And the public?

Dr. **PENNER**. Yes. Generally when the central banks intervene, we are talking about a very few billion.

Senator **BAUCUS**. How big a problem do we have here? How serious is this? Some people say that under a big speculative bubble the Federal budget deficits are hemorrhaging us to death. The trade deficit is another hemorrhage. We are living on borrowed time here, and it is a false sense of good times.

How great of a problem, in your judgment, do we have?

Dr. **PENNER**. I think it is a very serious problem. There are different dimensions to the problem. In our analyses, we have not said anywhere that it is in the nature of the problem that the system is going to collapse as of some certain date; rather, the problem of our deficit is something that eats away at you gradually. It's not something that necessarily provokes a crisis at a specific point in time—one that you can identify and say that it is the result of the budget deficit. That is why it is so hard to deal with politically.

But there are two levels of concern about the situation. One concern is that the deficit will get out of hand and explode in the sense that it so large and it adds so much to your interest that you can't keep up with it. You've got to monetize. That's one element of concern. We are not quite at that point, I think. We are very close, but we are not quite there.

The other concern is simply a matter of intergenerational equity. I think we are reducing the standards of living for future generations. Again, if our analysis is right, the economy is being restructured around that decision. We are indirectly financing the deficit largely with these international capital inflows and that is contorting the whole economy, depressing the goods industry and expanding the service industry.

Senator BAUCUS. I think the question I was asking, though, is what are the chances of a hard landing? of the U.S. dollar falling precipitously?

Dr. PENNER. I'm sorry. I misunderstood. We cite a hard landing as a risk of the whole thing. There could be a sudden loss of confidence in the U.S. dollar; people would start to extract capital; and the dollar would plummet.

Senator BAUCUS. What do you think the chances are?

Dr. PENNER. We don't forecast that. We think the chances of that hard kind of landing would be far, far less than 50 percent.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Symms.

Senator SYMMS. No questions.

The CHAIRMAN. Senator Heinz, any questions?

Senator HEINZ. No, sir.

The CHAIRMAN. Senator Long.

Senator LONG. No questions.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Mr. Chairman, do I understand only Dr. Penner——

The CHAIRMAN. Pete Dominici has asked that he come back. They have got some budget issues before them right now and I said he could testify first and then leave.

Senator BRADLEY. You mean he feels the Budget Committee is more important than this deliberation? [Laughter.]

The CHAIRMAN. Only today and tomorrow.

Senator BRADLEY. Let me ask you, Dr. Penner, do you think that if we put a surcharge on, that it would have any effect on the value of the dollar?

Dr. PENNER. Yes, sir. We believe that the dollar would rise. There is some controversy about that. You will probably hear a different testimony with regard to that in a few minutes. But our judgment is that the value of the dollar would rise.

Senator BRADLEY. So that if we put an import surcharge, the result would be to make our products more expensive abroad. Is that not correct?

Dr. PENNER. Our exports, yes, sir.

Senator BRADLEY. And make foreign imports cheaper.

Dr. PENNER. Yes, sir, but not to an extent that would offset the effect of the surcharge making them more expensive. It would only be a partial offset.

Senator BRADLEY. So that we would be protecting to a certain level our import sensitive industries. So we would be definitely hurting our export industries as the dollar increased. Is that not correct?

Senator DR. PENNER. That is correct—if the value of the dollar increased. Now, as I said, that is a point on which people can differ because the tariff can have a contrationary impact by lowering interest rates initially. You assume that is offset by monetary policy. By lowering interest rates more, you can have capital outflows that more than offset the trade effects on the dollars.

Senator **Bradley**. But it's your judgment that the dollar would increase in value?

Dr. **Penner**. That is our judgment, yes, sir.

Senator **Baucus**. Can I ask why?

Dr. **Penner**. I'm sorry. Could you repeat that?

Senator **Baucus**. What's your analysis? Why do you think the dollar would rise with a surcharge?

Dr. **Penner**. Well, it's a close call.

Senator **Bradley**. I think he wants to know the theoretical reason.

Dr. **Penner**. The theoretical reason? First of all, if you look at only what happens to the trade accounts, there is no doubt. Those forces would push the dollar upward. The really difficult question involves what happens to the capital accounts. I think it would be the general concensus in the profession—and you will hear this in a few minutes—that the imposition of this very large tax would have a contractionary impact on the economy. That impact could lower our interest rates, especially to the degree it is countered by looser monetary policy. That could push capital out of the economy, which causes the dollar to go down. It's a question of which of these two effects predominates and that is a very difficult question.

In the DRI analysis that we discuss in some detail in my more complete testimony, the dollar first goes up; then eventually its contractionary forces are offset with a time lag by a looser monetary policy. And after the whole thing is over and you have removed the surcharge, the dollar is actually lower.

So, again, there are all sorts of different analyses of this. But looking at a permanent surcharge, it is our judgment, based on our reading of the literature and these various studies, that the dollar would go up.

Senator **Baucus**. Thank you.

Senator **Bradley**. Do you have a percent?

Dr. **Penner**. No, sir, we don't have.

Senator **Bradley**. A range?

Dr. **Penner**. No. We weren't that bold.

Senator **Bradley**. Just said it would go up?

Dr. **Penner**. Yes. We thought it was pretty brave to identify the direction, given the uncertainty.

Senator **Moynihan**. Could I just break into this? The dollar went up 2 percent yesterday while we were sitting here talking about it. And you don't know why that happened, do you?

Dr. **Penner**. No, sir, I don't know why that happened. In fact, all of yesterday's news would have made me think it would go down. [Laughter.]

The **Chairman**. Doctor, thank you very, very much.

Dr. **Penner**. Thank you.

The **Chairman**. Now, you other two gentlemen have been very kind in waiting.

And if we could take Dr. Klein first, we would appreciate it. Doctor, thank you very much.

STATEMENT OF DR. LAWRENCE R. KLEIN, ECONOMIST, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Dr. KLEIN. Thank you, Mr. Chairman.

The testimony that I want to discuss has been developed in response to the discussions that are now encompassing us with an import surcharge for the United States. And to study this question, we have made use of a statistical model called Project LINK, which is some 15 years old. It is an international cooperative organization centered at the University of Pennsylvania.

The LINK system consists of 72 countries interrelated in bilateral trade flows across a few product categories.

We approach this problem from the point of view of trying to say what do these surcharges mean from a quantitative aspect. We looked at various menus of surcharge. And although the original proposal, called the Motorola proposal, was made as a combination of the surcharge and various budget cutting aspects and monetary intervention aspects, we wanted to look at the surcharge by itself, to isolate that question. So I've listed in my submitted testimony, with my colleagues, on page 14, seven scenarios, ranging from the pure imposition of a surcharge—temporary surcharge and a sliding surcharge, meaning 20 percent the first year, 15 percent the second year, 7 percent the third year and then phased out of existence—to the possibility of foreign retaliation, the possibility of exempting Canada and developing countries because of debt problems. We also considered a surcharge levied purely against Japan on a bilateral basis. Then we took up the questions, that really were discussed by Rudy Penner and the group assembled here, on whether the dollar would fall.

And I have an opinion. But this really is opinionated. We don't really understand why the dollar is going up and down, and Rudy was right that nobody quite knows why it went up yesterday, but I do believe that the scenario that assumes the budget deficit would be significantly reduced as a result of surcharge and would be followed by Federal Reserve accommodation with a lower interest rate and then a lower dollar is correct. That's the soft landing case.

The hard landing case concerns the question of confidence. And if we take the escape route, saying that we don't know why the dollar is where it is, but it must be a matter of confidence in the American economy, we have put forward the assumption that the imposition of this surcharge is interpreted by the world as a last resort effort by the United States to turn around its current account, and that capital would move out. The dollar would fall, and then interest rates would go up. That's the crash landing or hard landing scenario.

So we have this range of scenarios and we have worked out various charts and diagrams to show their effects. And there are two kinds of effects that we have summarized in this paper; namely, the effects on the United States and the effects on the total world economy.

The effects on the United States are laid out in tables 7 and 8—one table gives the first-year effects, table 7, and table 8 cumulates effects over a 5-year period.

Our conclusion, looking at these tables, is that the imposition of a surcharge with these various combinations, by and large, would be a setback for American production. The only case in which there is an increase in production is the case in which there are very strong side effects as the result of the dollar depreciation and interest rate cuts. So it isn't the surcharge itself, but it is what the surcharge does on the money markets that brings about a change.

The surcharge is big enough so that there is a very noticeable change in the Federal budget deficit and in the current account in a favorable direction. This is hampered or cut back if there is significant retaliation. Many results for the first year carryover to the total 5-year period as well.

And if you look at the world, the total world effect, our results would say that world GNP or world trade is set back. World trade is set back a good deal more, in a definitive sense, than is world GNP, but world GNP in the short run would be hurt, and even, in many of these scenarios, for the long run.

Our conclusion is that this is an interesting proposition. It has, by itself, a perverse effect. If it induces very favorable domestic budgetary situations, not totally favorable, but an improvement, and if it induces a very accommodating and favorable reaction by the Federal Reserve to deficit reduction, then it can have some good side effects.

My point would be that it would be better to get these budgetary effects other ways than through an import surcharge.

[The prepared statement of Dr. Klein follows:]

Import Surcharges, U.S. Deficits, and the World Economy

Lawrence R. Klein, Peter Pauly, and Christian E. Petersen

April 1985

Project LINK

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1. Introduction

Coming out of the recession, the U.S. economy has outperformed all other industrial nations by a large margin. All indications are that the current year, while having some significant growth slow down, will still be one of high performance results, compared with the average of other OECD countries. Unemployment has come down to a little more than 7 percent, and consumer price inflation appears to be under control, after all.

And yet, two major, and to a large extent related, signs of fundamental disequilibrium in the U.S. economy remain: the continuing Federal budget deficit and mounting deficits in the trade balance. It is this latter problem that will be addressed in this note. Last year's trade deficit jumped to more than $120 billion, an increase of almost 80 percent over the preceeding year. The deficit for 1985 may well end up being in the neighborhood of $140 billion. Combined with reduced foreign investments by Americans and an increasing service flow on the debt to foreigners, the mounting trade deficit has contributed to a persistent current account deficit in excess of $100 billion, which has made the United States a net debtor country for the first time since the early 1900s.

There appears to be a growing judgment, particularly among policy makers and in the business community, that the trade deficit is to a large extent the result of trade practices that are claimed to be tilted against the United States, in that foreigners subsidize exports and impose tariffs or non-price import barriers. Much of this perception is directed towards Japan. While the increase of the bilateral trade deficit with Japan seems to be the most visible, a careful analysis shows that the imbalances are by no means limited to U.S.-Japanese trade.

One of the most publicized protectionist proposals presently under discussion calls for the imposition of a temporary surcharge on imports. Proponents of this idea see it as an instrument to correct the imbalance of trade flows, while at the same time generating revenues to contribute to a reduction in the Federal budget deficit. It thus addresses the two major disequilibria at once.

It is the purpose of this study to evaluate systematically the effects of such a surcharge on the U.S. economy and on the world economy as a whole. The global econometric model system of Project LINK is used to simulate the direct impact of such a surcharge on U.S. trade and domestic performance, as well as the repercussions of such a policy all over the world.[1] In particular, an attempt is made to assess the sensitivity of the basic results to alternative assumptions about domestic and foreign policy reactions.

2. The LINK Baseline Forecast

The LINK world outlook for the period 1985-1990 is summarized in Tables 1-5. The first of these tables reports the results for nominal and real world trade, world trade prices, and FOB trade balances for regional aggregates.

Following an extremely strong growth of at least 8 percent in 1984, real world trade continues to grow at about 7 percent in 1985. Thereafter, growth rates are expected to decline to approach a relatively steady path with rates around 5 percent. World export prices (in Dollars) fall by about 1 percent in 1985, and resume a path of moderate increase in the outyears. The present decline is caused by both weak oil prices and the strength of the US Dollar.

The trade balance forecast reflects persistent disequilibria on a world scale. The U.S. trade balance continues to deteriorate, despite a moderate

[1] L.R. Klein, Peter Pauly, P. Voisin, "The World Economy -- A Global Model," Perspectives in Computing, 2 (May 1982), 4-17.

Table I

World Exports, Imports and Trade Balances (f o b)
Project LINK - University of Pennsylvania

Post Meeting Forecast, April 1985

	1984	1985	%chg	1986	%chg	1987	%chg	1988	%chg	1989	%chg	1990	%chg
				*****************		Billions of U.S. $		*****************					
Industrialized Countries													
Exports	1251.04	1330.66	6.4	1481.08	11.3	1655.60	11.8	1820.13	9.9	1996.51	9.7	2203.66	10.4
Imports	1303.70	1356.09	4.0	1520.83	12.1	1690.42	11.2	1861.88	10.1	2049.45	10.1	2257.84	10.2
Balance	-52.66	-25.43		-39.76		-34.82		-41.75		-52.94		-54.18	
North America													
Exports	303.80	325.80	7.2	356.13	9.3	394.60	10.8	437.99	11.0	487.71	11.4	545.12	11.8
Imports	397.94	429.52	7.9	481.66	12.1	525.03	9.0	584.73	11.4	649.86	11.1	722.02	11.1
Balance	-94.13	-103.72		-125.53		-130.43		-146.74		-162.15		-176.91	
Developed East													
Exports	193.87	224.63	15.9	247.24	10.1	262.31	6.1	282.42	7.7	301.73	6.8	326.74	8.3
Imports	151.68	158.20	4.3	169.84	7.4	179.87	5.9	195.94	8.9	219.64	12.1	244.97	11.5
Balance	42.19	66.43		77.40		82.44		86.48		82.09		81.77	
EEC													
Exports	582.65	602.62	3.4	677.70	12.5	771.69	13.9	848.55	10.0	929.57	9.5	1021.76	9.9
Imports	576.92	582.61	1.0	661.39	13.5	751.87	13.7	825.62	9.8	903.64	9.4	987.48	9.3
Balance	5.73	20.01		16.31		19.83		22.93		25.93		34.28	
Rest of Industrialized													
Exports	153.43	159.59	4.0	179.22	12.3	202.60	13.1	223.89	10.5	247.63	10.6	276.85	11.8
Imports	157.48	165.35	5.0	184.05	11.3	205.63	11.7	224.01	8.9	242.03	8.0	265.94	9.9
Balance	-4.06	-5.76		-4.83		3.02		-0.12		5.61		10.91	
Developing Countries													
Exports	493.67	517.01	4.7	555.41	7.4	613.63	10.5	682.13	11.2	759.02	11.3	844.32	11.2
Imports	440.60	482.13	9.4	528.12	9.5	587.24	11.2	652.35	11.1	721.79	10.6	798.37	10.6
Balance	53.07	34.87		27.29		26.39		29.78		37.23		45.95	
OPEC													
Exports	182.88	178.77	-2.2	187.38	4.8	205.38	9.6	226.24	10.2	250.47	10.7	276.87	10.5
Imports	135.84	146.04	7.5	157.67	8.0	174.17	10.5	192.93	10.8	212.91	10.4	235.74	10.7
Balance	47.04	32.74		29.71		31.20		33.31		37.56		41.13	
Africa													
Exports	25.54	26.50	3.7	27.88	5.2	29.10	4.4	30.85	6.0	32.68	5.9	34.76	6.4
Imports	27.62	28.80	4.3	30.40	5.6	32.21	6.0	34.33	6.6	36.59	6.6	39.00	6.6
Balance	-2.07	-2.30		-2.51		-3.11		-3.48		-3.91		-4.23	
Asia incl China													
Exports	187.28	208.04	11.1	230.71	10.9	259.62	12.5	293.59	13.1	331.06	12.8	372.23	12.4
Imports	194.81	217.54	11.7	241.60	11.1	271.25	12.3	304.01	12.1	340.89	12.1	380.36	11.6
Balance	-7.52	-9.50		-10.89		-11.63		-10.42		-9.83		-8.13	
Middle East non-oil													
Exports	8.62	9.26	7.4	9.93	7.2	10.86	9.4	11.83	9.0	13.27	12.2	14.83	11.8
Imports	21.06	22.56	7.1	24.39	8.1	26.08	6.9	27.90	7.0	29.53	5.9	31.26	5.8
Balance	-12.44	-13.30		-14.47		-15.22		-16.06		-16.26		-16.42	
Western Hemisphere													
Exports	89.35	94.43	5.7	99.52	5.4	108.68	9.2	119.62	10.1	131.54	10.0	145.63	10.7
Imports	61.28	67.20	9.7	74.07	10.2	83.53	12.8	93.19	11.6	101.87	9.3	112.02	10.0
Balance	28.08	27.23		25.45		25.14		26.43		29.67		33.61	
C P E excl China													
Exports	196.76	204.06	3.7	217.18	6.4	232.91	7.2	251.52	8.0	269.24	7.0	290.40	7.9
Imports	184.34	193.60	5.0	208.68	7.8	223.89	7.3	241.40	7.8	257.58	6.7	280.73	9.0
Balance	12.42	10.45		8.50		9.03		10.12		11.66		9.66	
Stat Discrep	-11.77	-10.71		4.00		-0.10		1.96		3.06		-2.07	
World Exports	1941.47	2051.72	5.7	2253.67	9.8	2502.14	11.0	2753.77	10.1	3024.78	9.8	3338.38	10.4
World Export Price	3.02	3.00	-1.0	3.16	5.6	3.37	6.5	3.54	5.0	3.69	4.2	3.86	4.6
World Exports real	641.89	684.87	6.7	712.43	4.0	742.46	4.2	778.22	4.8	820.11	5.4	865.50	5.5

World Gross National Product (1970 U.S. $)
Project LINK - University of Pennsylvania

Post-Meeting Forecast, April 1985

	1984	1985	1986	1987	1988	1989	1990	Mean
				************** Growth Rates **************				
Industrialized Countries	5.0	3.3	2.7	3.2	3.1	3.2	3.4	3.4
North-America	6.6	3.3	2.7	3.5	3.0	3.2	3.4	3.7
Developed East	5.8	4.9	3.7	3.7	3.9	4.0	4.0	4.3
EEC	2.3	2.4	2.1	2.5	2.7	2.0	3.1	2.5
Rest of Industrialized	2.6	2.6	2.5	2.8	3.0	3.3	3.3	2.9
Developing Countries	4.9	4.5	4.5	4.9	4.9	5.1	5.0	4.8
OPEC	1.6	3.0	3.1	4.0	4.3	4.6	4.6	3.6
Africa	2.1	1.7	1.8	2.3	2.4	2.4	2.6	2.2
Asia incl China	7.9	6.2	6.1	5.8	5.9	5.9	5.6	6.2
Middle East non-oil	1.0	4.1	4.6	4.6	4.7	4.6	5.1	4.1
Western Hemisphere	2.6	3.0	2.7	4.3	4.0	4.4	4.4	3.6
C.P.E. excl China	3.7	3.3	3.4	3.3	3.2	3.1	3.2	3.3
World total	4.7	3.5	3.1	3.6	3.5	3.6	3.7	3.7

Table 3

OECD Unemployment Rates
Project LINK - University of Pennsylvania

Post-Meeting Forecast, April 1985

	1984	1985	1986	1987	1988	1989	1990	Mean
				*** Percent ***				
OECD	8.7	8.7	8.8	8.8	8.7	8.6	8.3	8.6
North-America	7.9	7.6	7.6	7.4	6.8	6.7	6.6	7.2
Developed East	3.1	3.0	3.1	2.9	3.0	3.0	2.9	3.0
EEC	10.1	10.5	10.8	10.9	11.1	10.7	10.3	10.6
Rest of OECD	15.2	15.2	15.4	15.8	16.0	16.4	16.1	15.7

Note: Excl. Greece, Iceland, The Netherlands and Switzerland

Table 4

OECD Private Consumption Deflators
(Inflation rates in local currencies weighted with GNP in current U.S. $)
Project LINK - University of Pennsylvania

Post-Meeting Forecast, April 1985

	1984	1985	1986	1987	1988	1989	1990	Mean
			*** Percentage Change ***					
OECD	5.0	4.5	4.4	4.5	4.7	4.7	5.1	4.7
North-America	3.3	3.5	3.0	4.3	4.7	4.4	5.0	4.1
Developed East	2.9	2.6	2.5	2.3	3.0	3.0	2.0	2.7
EEC	7.3	5.7	4.9	4.7	4.5	4.5	4.0	5.2
Rest of OECD	14.5	13.6	12.3	10.6	10.0	11.4	12.2	12.1

Definition of aggregates
- North America
  - Canada, U.S.A.
- Developed East
  - Australia, Japan, New Zealand
- EEC
  - Belgium/Luxemburg, Denmark, France, Germany (F.R.), Greece, Ireland, Italy, Netherlands, U.K.
- Rest of Industrialized
  - Finland, Iceland, Israel/Malta, Norway, Portugal, Spain, Sweden, South Africa, Switzerland, Turkey, Yugoslavia
- OPEC
  - Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Other West Asia Oil Exporters, Saudi Arabia, Venezuela
- Africa
  - Other Africa, Africa Least Developed
- Asia
  - China, Hong-Kong, India, Korea, Malaysia, Other South East Asia, Pakistan, Philippines, Singapore, South East Asia Least Developed, Taiwan, Thailand
- Middle East non oil
  - Egypt, West Asia Oil Importers
- Western Hemisphere
  - Argentina, Bolivia, Brazil, Caribbean, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay
- CPE
  - Bulgaria, Czechoslovakia, Germany (G.D.R.), Hungary, Poland, Romania, U.S.S.R.

Note: Regions are defined in the respective country tables.

re-adjustment of the Dollar. Japan and the EEC, most notably Germany, continue to improve their balances, fueled by strong manufacturing goods exports to industrial and developing countries alike. The trade surplus for the Developing Countries declines temporarily, reflecting a fall in oil revenues during 1985 to 1987. The balances improve gradually thereafter. Particularly noticeable is the trade surplus for Latin America (Western Hemisphere); even this is, however, not sufficient to maintain current debt levels. The centrally planned economies are expected to maintain their present level surpluses in the order of Bill. $10-12.

In Table 2 we report aggregate GNP growth rates for the same set of regional groupings. World GNP growth is expected to drop to 3.5% following 4.7% in 1984. A mild growth recession is seen for 1986, with rates picking up steadily over the medium term. The short-run pattern is dominated primarily by the cycle in the U.S. Rates of growth for North America drop sharply in 1985, and even further in 1986. A return to a stronger expansionary pace can, however, be expected in the outyears. The major European economies are finally picking up pace. The results suggest that 1985 can be expected to be an even better year than 1984 for Europe as a whole. While this reflects at least a moderate recovery for Europe, the average rates remain well below the OECD average. In contrast, Japan is expected to grow at rates above the OECD average. GNP growth in 1985 is likely to be in the neighborhood of 5 percent; in the medium term rates are expected to be at or above 4 percent.

The Developing Countries are presently seen to be growing at rates well in excess of previous expectations. The Asian countries, in particular the Asian NICs, continue to grow strongly, though not at rates experienced in the late 1970s or early 1980s. China's economy appears to be blossoming beyond many expectation. The region as a whole will reach average growth rates in the range of 5-7 percent during the entire forecast period. Latin America is picking up pace again, even though setbacks in individual countries are likely. OPEC will recover gradually, with oil exports slowly following the general world recovery. The only troubling element in the developing countries outlook is the persistent relative stagnation in Africa, in particular, middle-and low-income countries in Central Africa. Growth rates in the range of 2 to 2.5 percent are not acceptable. Given current population trends, the present forecast implies a continued decline in per capita real income for the region as a whole.

The centrally planned economies are seen to grow at a steady rate of slightly above 3 percent. While these rates are roughly at par with world averages, they do not compare favorably with growth rates for the region during the period prior to the adjustment caused by the second oil shock.

The second disturbing aspect of the present forecast is the persistence of high unemployment rates for the OECD area. A continued improvement in North America contrasts sharply with stubbornly high rates in Europe. All major EEC countries are confronting the prospects of continued high unemployment at rates in the neighborhood of 10 percent, while in some of the smaller countries the labor market situation is even worse. The diversity between the U.S. and Europe reflects the higher degree of structural unemployment in Europe. No significant improvement is expected for years to come. Work sharing arrangements and reductions in average hours spread slowly, and their effects on employment remain uncertain.

Helped by the strong US-Dollar, commodity prices have been restrained. Inflation in the major OECD countries appears to be well under control. In addition, the apparent commitment on the part of monetary authorities in these countries to maintain policy stances geared towards preserving relative price

Table 5

US

POST-MEETING FORECAST, APRIL 1985 PROJECT LINK TUE APR 9 14:07:38

AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)

			1984-1	1985-1	%CHG	1986-1	%CHG	1987-1	%CHG	1988-1	%CHG	1989-1	%CHG	1990-1	%CHG
PRIV CONSUMPTION	136	CF$	2343.1	2508.9	7.1	2671.5	6.5	2859.5	7.0	3081.9	7.8	3299.5	7.1	3568.2	8.1
PUBL CONSUMPTION	206	GVPT$	747.9	819.4	9.6	881.1	7.5	954.3	8.3	1032.8	8.2	1120.4	8.5	1214.2	8.4
FEDERAL EXP	203	GVPF$	295.50	332.73	12.6	357.48	7.4	387.44	8.4	420.57	8.6	459.23	9.2	500.16	8.9
DEFENSE EXP	204	GVPFD$	221.52	247.45	11.7	272.31	10.0	300.45	10.3	330.79	10.1	366.85	10.9	405.00	10.4
PRIV INVESTMENT	194	IBI$	638.9	669.9	4.8	731.1	9.1	812.8	11.2	868.9	6.9	960.3	10.5	1069.8	11.4
INVENTORY CHANGE	195	IBII$	57.949	36.539	-36.9	28.709	-21.4	23.841	-17.0	16.886	-29.2	31.921	89.0	40.036	25.4
EXPORT GOOD+SERV	1572	TEB$	363.48	383.31	5.5	416.53	8.7	459.90	10.3	510.62	11.1	570.11	11.7	637.15	11.8
IMPORT GOOD+SERV	1531	IMB$	420.72	472.31	12.3	530.54	12.3	576.82	8.7	642.06	11.3	715.97	11.5	803.65	12.2
GROSS NATL PROD	238	GNP$	3672.7	3909.2	6.4	4169.8	6.7	4509.4	8.1	4852.1	7.6	5234.4	7.9	5685.0	8.6

AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, 1972 PRICES)

			1984-1	1985-1	%CHG	1986-1	%CHG	1987-1	%CHG	1988-1	%CHG	1989-1	%CHG	1990-1	%CHG
PRIV CONSUMPTION	49	CE	1062.2	1102.4	3.8	1132.1	2.7	1163.4	2.8	1199.3	3.1	1231.5	2.7	1269.3	3.1
- DURABLES	58	CFD	178.05	188.38	5.8	194.40	3.2	202.04	3.9	209.45	3.7	218.30	4.2	226.50	3.8
- NON DURABLES	123	CFN	393.55	405.64	3.1	415.17	2.3	425.13	2.4	437.09	2.8	446.71	2.2	460.92	3.2
- SERVICES	38	CFS	490.62	508.38	3.6	522.52	2.8	536.20	2.6	552.79	3.1	566.54	2.5	581.76	2.7
PUBL CONSUMPTION	47	GVPT	302.10	316.89	4.9	323.61	2.1	330.94	2.3	339.84	2.7	348.81	2.6	357.72	2.6
FEDERAL EXP	211	GVPF	122.50	132.59	8.2	135.33	2.1	138.36	2.3	142.50	3.0	146.91	3.1	151.25	3.0
DEFENSE EXP	208	GVPFD	89.60	96.87	8.1	101.12	4.4	105.14	4.0	108.64	3.3	112.63	3.7	116.56	3.5
NON RES INVEST	48	IBFN	204.87	222.01	8.4	239.98	8.1	260.01	8.4	271.20	4.3	285.90	5.4	305.09	6.7
RESIDENTIAL INVT	28	IBFR	60.195	61.173	1.6	63.790	4.3	65.338	2.4	65.588	0.4	66.973	2.1	69.312	3.5
INVENTORY CHANGE	39	IBII	23.988	16.785	-30.0	13.477	-19.7	11.037	-18.1	8.384	-24.0	13.511	61.1	16.557	22.5
EXPORT GOOD+SERV	1573	TEB	146.02	152.12	4.2	159.26	4.7	168.33	5.7	179.28	6.5	191.22	6.7	203.45	6.4
IMPORT GOOD+SERV	1532	IMB	156.44	177.22	13.3	192.53	8.6	199.37	3.6	210.99	5.8	224.73	6.5	241.20	7.3
GROSS NATL PROD	38	GNP	1630.1	1684.1	3.4	1730.6	2.7	1790.7	3.4	1852.7	2.9	1913.2	3.3	1980.2	3.5

BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)

			1984-1	1985-1	%CHG	1986-1	%CHG	1987-1	%CHG	1988-1	%CHG	1989-1	%CHG	1990-1	%CHG
EXPORTS SITC 0-1	601	VXL01	31.741	36.135	13.8	38.353	6.1	43.205	12.6	49.474	14.5	56.085	13.4	63.515	13.2
SITC 2+4	602	VXL24	22.410	25.265	12.7	29.281	15.9	29.973	2.4	32.323	7.8	34.343	6.3	36.347	5.8
SITC 3	603	VXL3	11.880	12.457	4.9	13.790	10.8	13.803	0.0	14.889	7.9	15.943	7.1	17.122	7.4
SITC 5-9	604	VXL59	152.24	159.69	4.9	169.34	6.0	188.40	11.3	210.55	11.7	237.77	12.9	268.42	12.9
ALL GOODS	605	VXL09	216.86	233.54	7.7	250.77	7.4	275.47	9.8	307.23	11.5	344.15	12.0	385.41	12.0
IMPORTS SITC 0-1	614	VML01	21.879	25.310	15.7	28.613	13.0	31.009	7.9	35.114	12.0	38.691	10.2	42.513	9.9
SITC 2+4	615	VML24	10.299	10.987	6.7	12.254	11.5	13.342	8.9	14.375	7.7	16.170	12.5	18.101	11.9
SITC 3	616	VML3	58.575	58.725	0.3	63.288	7.8	68.527	8.3	77.043	12.4	84.085	9.1	91.206	8.5
SITC 5-9	624	VML59	227.40	249.00	9.5	281.44	13.0	304.73	8.3	339.67	11.5	379.24	11.6	424.70	12.0
ALL GOODS	625	VML09	318.15	344.11	8.2	385.79	12.1	417.80	8.3	466.20	11.6	518.10	11.2	576.52	11.3
FOB TRADE BAL	644	TBL	-101.3	-110.6	-9.1	-135.0	-22.1	-142.2	-5.3	-159.0	-11.8	-174.0	-9.5	-191.1	-9.8
CURRENT ACCOUNT	1435	TBPCABOP	-101.6	-115.7	-13.9	-135.5	-17.1	-145.4	-7.3	-162.1	-11.5	-180.7	-11.5	-196.9	-9.0
AVG EXCH RATE	1446	REXAV75W	82.568	78.632	-4.8	84.420	7.4	89.032	5.5	89.457	0.5	89.727	0.3	89.691	0.0

KEY ECONOMIC INDICATORS

			1984-1	1985-1	%CHG	1986-1	%CHG	1987-1	%CHG	1988-1	%CHG	1989-1	%CHG	1990-1	%CHG
GNP DEFLATOR	74	PDGNP	224.03	230.73	3.0	239.68	3.9	250.54	4.5	261.86	4.5	273.56	4.5	287.09	4.9
PRIV CONS DEFL	4	PDCE	220.37	227.58	3.3	235.96	3.7	245.78	4.2	256.85	4.5	267.90	4.3	281.09	4.9
EXP GOODS DEFL	1570	PDTEBGTE	267.07	265.80	-0.5	274.54	3.3	287.72	4.8	301.01	4.6	316.57	5.2	333.88	5.5
IMP GOODS DEFL	1529	PDTMBGTE	280.87	276.85	-1.4	287.70	3.9	307.42	6.8	329.60	7.2	350.95	6.5	372.37	6.1
WAGE RATE INDEX	370	WRCMF$	13.579	14.149	4.2	14.777	4.4	15.518	5.0	16.217	4.5	16.983	4.7	17.701	4.2
UNEMPLOYMENT(%)	9	NRUT	7.5025	7.3254	-2.4	7.3274	0.0	7.0770	-3.4	6.5648	-7.2	6.4819	-1.3	6.2735	-3.2
CAPACITY UTIL(%)	89	CUMIP	83.697	83.720	0.0	82.812	-1.1	83.475	0.8	84.565	1.3	86.817	2.7	88.934	2.4
FED FUNDS RATE	433	FRMFF	10.227	8.210	-19.7	7.545	-8.1	9.088	20.4	9.685	6.6	9.390	-3.0	8.905	-5.2
PRIME RATE	671	FRMPRIME	12.042	10.225	-15.1	9.749	-4.7	11.082	13.6	11.889	7.2	11.592	-2.5	11.401	-1.6
TREAS BILL RATE	111	FRMTB3MY	9.5225	8.2494	-13.4	8.2002	-0.6	9.3760	14.3	9.7889	4.4	9.4931	-3.0	9.2020	-3.1
UNBORROWED RES B	241	FRENS*	39.241	42.203	7.5	45.448	7.7	46.245	1.8	48.808	5.5	51.272	5.1	54.420	6.1
MONEY SUPPLY M1B	355	FM1B$	543.80	578.50	6.4	614.04	6.1	648.49	5.6	691.78	6.7	734.48	6.2	782.05	6.5
FED GOV S/D	112	GVSURPF$	-175.7	-192.5	-9.5	-199.9	-3.8	-212.2	-6.2	-216.3	-1.9	-216.4	0.0	-205.3	5.1

stability, supports a rather optimistic outlook for inflation. Even for the Rest of OECD, where we find, among others, several high-inflation Southern European countries, progress is clearly visible.

In Table 5, the baseline forecast for the U.S. is summarized. Following a growth recession in 1986, the economy is expected to pick up again with rates of around 3 percent in the medium-term. Inflation is expected to remain below 5 percent. The Federal budget deficit continues to be in the range of $200-220 billion annually, while the f.o.b. trade balance deteriorates continually, from about $100 billion in 1984 to about $190 billion in 1990, even with a modest dollar depreciation during the next two years.

3. LINK Scenarios

The most widely discussed proposal has been put forward by Motorola Corp., and is being advocated, among others, by Congressman Lundine of New York. It calls for the imposition of a three-year sliding surcharge from 1986 to 1988, with rates of 20 percent, 15 percent, and 7 percent, respectively. The original Motorola proposal combines this with a deficit-reduction package, which consists of spending cuts and tax increases alike. In this study we will not consider these additional measures, so as to be able to discuss the effects of an import surcharge in isolation. The surcharge, by assumption, will be imposed on all goods, without exception. There appears to be some discussion to limit the measure to dutiable goods only, which would exclude about 30 percent of all imports; this is, however, not part of the present study.

The "Motorola" proposal is our basic policy scenario, and it turns out that the effects of such a policy are, to a large extent, determined by domestic and foreign policy responses, by expectations of exporters and importers as well as by foreign exchange traders around the world, and by the regional coverage of such a surcharge. To this effect, we will examine five issues in detail:

(i) Is there a need to exempt certain countries from a surcharge, based on good trade relations and/or other economic and political criteria? For example, it is often argued that the indiscriminate imposition of a surcharge against all trading partners may place a particular burden on debt-ridden developing countries. Following that view, there is a non-negligible possibility that the imposition of trade barriers vis-a-vis certain countries may trigger an avalanche of defaults with unpredictable repercussions on the United States. Also, it is argued that -- under any circumstances -- Canada must be exempted. We will therefore examine to what extent an exemption of Canada and all the Developing Countries affects the projected outcome.

(ii) The effects of a surcharge will depend on whether or not there will be retaliation of some kind from trading partners. Opponents of a surcharge argue that such a course of events will be more than likely, citing recent remarks particularly from Common Market representatives. They also warn that such retaliation could lead to a severe disruption of world trade, and subsequently a world depression, just as retaliation against the Smoot-Hawley tariffs in the 1930s may have contributed to the worsening of the subsequent depression. On the contrary, proponents argue that the desire to retain U.S. markets -- and the temporary nature of the proposed U.S. measure -- would lead foreign countries to prefer not to retaliate. One of the scenarios presented below will thus examine the effects of a foreign retaliation in kind.

(iii) Any tariff will most likely be accompanied by adjustments in policy instruments both domestically and abroad. In particular, the effectiveness of such a tariff will depend critically upon the Federal Reserve response and monetary policies abroad. The central issue is whether the FED can be expected to accommodate the domestic price increase, or to maintain a fixed supply of unborrowed reserves. In the latter case, the interest rate response to a surcharge will be ambiguous, since the reduction in transactions demand for money and the reduction in Federal borrowing requirements may well be compensated by the effects of inflationary expectations. The general result, however, is for an interest rate decline because of the implied decline in velocity.

(iv) Market participants on goods, money, and international foreign exchange markets are highly responsive to any U.S. policy measure. Given the volatility of present financial markets, any major policy shift cannot but have significant impacts on these markets. In particular, market reactions will differ depending on whether or not such a policy will be perceived to be a promising attempt to tackle the fundamental disequilibria. While there is some indication that a surcharge will contribute to a deficit reduction both in the trade balance and the Federal budget, such a measure may, on the other hand, also be interpreted as an attempt to avoid the necessary domestic adjustment by taxing foreigners. Under such circumstances the net effect on market confidence may well be negative.

(v) The previous two issues lead directly to the final and most important aspect of these scenarios: the exchange rate response to a temporary surcharge. There has been a substantial debate about the likely response of currency rates to a tariff. In the absence of any definite policy reaction — and disregarding market sentiments -- the changes in fundamentals should unambiguously cause an appreciation of the Dollar. The major factor underlying this movement would be the trade balance improvement. One of our scenarios will be based on this assumption.

A contrasting view can, however, quite easily be established. A depreciation caused by either a precipitous capital outflow or an easing of monetary policy is quite possible. Some economists think that the effect of a surcharge on the dollar's exchange value would be to trigger a capital flight causing the dollar to fall and interest rates to rise — via "crowding out" — together with restrictive central bank monetary policy in the face of higher domestic prices. This sequence of events forms the basis of assumptions for our scenario VII. A preferred scenario, however, is that the deficit reduction that would follow the collection of the surcharge by the Treasury would pave the way for easier monetary policy (in compensation for the deficit reduction), lower interest rates, and a depreciating dollar. These assumptions are used for scenario VI. This latter scenario broadly corresponds to a "soft landing" view of the impact of a surcharge while the former would mimic a "crash landing" case. Both variants, while assuming that these effects dominate the improvement in the trade balance, are associated with quite different interest rate movements and, consequently, rather contrasting assessments of the effectiveness of a surcharge.

Exchange rate models have, over the past few years, not proven to be accurate in the short run. The forecast record reflects the inability to trace back the present strength of the Dollar to market fundamentals. Rather than relying on a model of endogenous exchange rate response, we have imposed alternative reactions in our various scenarios.

In addition to these aspects, which will be analyzed in this study, there is some debate about the extent to which the surcharge will be passed through to consumers in terms of higher prices for imported goods. Proponents of the surcharge proposal argue that the percentage pass-through can be expected to be close to zero, based on the assumption that a pre-announced temporary surcharge will induce foreign exporters to absorb the losses (or reductions in profit margins) in order to maintain market shares. Econometrically, it turns out to be rather difficult to obtain such a response in a given model. While there are endogenous reactions of export prices in affected countries, the zero pass-through assumption would imply a change in behavior and would have to be imposed exogenously. In addition to this technical aspect, it remains questionable whether foreigners would be prepared to be taxed by U.S. authorities for a period of a few years to finance the Federal deficits without some form of price adjustment.

Finally, since much of the current debate is centered around the bilateral trade relationships with Japan, we will also examine the impacts of a surcharge imposed on imports from Japan only.

Combining these various considerations leads us to a set of scenarios, which -- from different angles -- attempt to assess the economic impacts of an import surcharge under alternative assumptions regarding the reaction of market participants and policy-makers world-wide. These scenarios are summarized in Table 6.

Table 6: Summary of Scenarios

Scenario	Policy Assumption
I	Sliding surcharge (20%, 15%, 7%)
II	Sliding surcharge (20%, 15%, 7%) foreign retaliation (20%, 15%, 7%)
III	Sliding surcharge (20%, 15%, 7%) Canada and Developing countries exempt
IV	Sliding surcharge (20%, 15%, 7%) Japan only
V	Sliding surcharge (20%, 15%, 7%) dollar appreciation (10% sustained)
VI	Sliding surcharge (20%, 15%, 7%) interest rate decline (180 basis points sustained) dollar depreciation (10% sustained)
VII	Sliding surcharge (20%, 15%, 7%) dollar depreciation (10% sustained) interest rate increase (200 basis points sustained)

4. Results

Standard economic theory suggests that a country that levies a tariff potentially suffers from two types of cost. A production cost results from the fact that domestic and foreign firms allocate their resources in response to distorted prices for their goods, rather than to the true international market prices. A consumption cost occurs since consumers will end up purchasing fewer goods -- without benefit of import substitution -- than they would have preferred to purchase if they had been free to buy at the international market price. Evaluating such hypotheses, however, requires an explicit welfare analysis, while in this study we shall concentrate on standard macroeconomic aggregates. The analysis in terms of trade balance and price effects, impacts on real activity, and the Federal deficit, while not completely capturing the spirit of traditional welfare concepts, is much more in line with the current political debate.

4.1 Effects on the U.S.

The effects on the United States are summarized in Tables 7 and 8, which compare the first-year effects of various scenarios on a selected set of macroeconomic indicators, and the effects over the entire simulation period, respectively. Detailed tables can be found in Appendix A.

The most important conclusion to be drawn from the basic surcharge scenario without retaliation (no exchange rate and policy reaction) in the first row of either table is that, while an immediate reduction of the Federal deficit and a significant trade balance improvement can indeed be expected, it will lead to a loss of real activity to the extent that domestic production and existing stocks cannot fully compensate for the loss of imported goods at favorable prices. Assuming a full pass-through, consumer prices will rise by about 6/10 of a percent. If both Canada and the LDCs were exempt from the surcharge, the effects on the Federal deficit and the trade balance would be substantially reduced, in effect by more than half. In that case, our results indicate that there would be even a slight increase in GNP, caused by the redirection of trade to Canada, which indirectly benefits U.S. exports. Finally, a surcharge against Japan alone would generate only a minor trade balance shift, with slight improvements in the Federal deficit; the real effects of such a policy are hardly discernible. It is noteworthy that in the long run, in all cases, a slight reduction in consumer prices can be

Comparison of First Year Effects Under Various Import Surcharge Scenarios

Scenario	Exports $	Imports $	Trade Balance $	Federal Budget $	GNP %	Interest Rates (basis points)	Unemployment Rate %	Consumer Prices %
Scenario I: Sliding surcharge	.1	-16.3	16.4	59.8	-.2	-.40	.2	.6
Scenario II: Sliding surcharge foreign retaliation	-31.8	-15.0	-16.8	42.3	-.9	-70	.5	.5
Scenario III: Sliding surcharge Canada and Deve exempt	1.1	-4.3	5.4	26.7	.1	-10	0	.3
Scenario IV: Sliding surcharge Japan only	.5	-2.2	2.7	11.5	0	-5	0	.1
Scenario V: Sliding surcharge dollar appreciation	-11.8	-33.5	21.7	56.7	-.4	-40	.3	.3
Scenario VI: Sliding surcharge dollar depreciation interest rate decline	14.5	6.8	7.7	70.7	.5	-180	-.1	.7
Scenario VII: Sliding surcharge dollar depreciation interest rate increase	13.5	.4	13.1	55.5	-.4	120	.2	1.2
Baseline (1986)	250.8	385.8	-135.0	-199.9	2.7	8.2	7.3	3.9

Note: All data are presented as changes from baseline, except for the last line of the table, which present levels. Changes in exports, imports and the trade balance are measured in billions of U.S. dollars, fob. Changes in the federal budget are presented in billions of U.S. dollars. Changes in GNP, unemployment rates and inflation rates are presented in percentage points. Changes in interest rates are measured by differences from Treasury Bill rate in basis points.

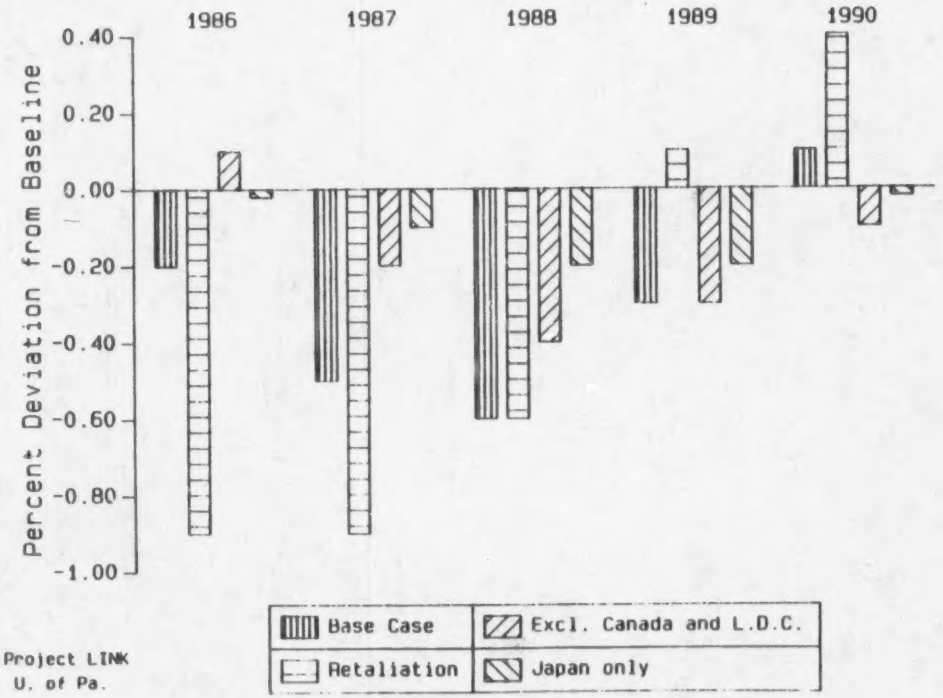
Table 8

Comparison of Five-Year Effects
Under Various Import Surcharge Scenarios

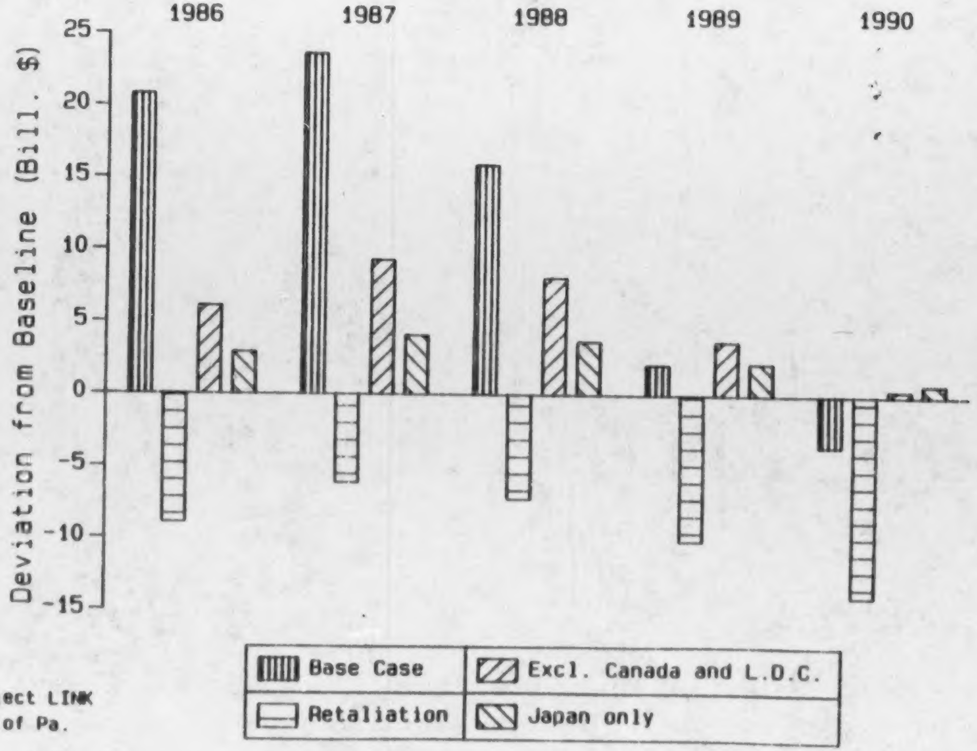
Scenario	Exports $	Imports $	Trade Balance $	Federal Budget $	GNP %	Interest Rates (basis points)	Unemployment Rate %	Consumer Prices %
Scenario I: Sliding surcharge	-7.1	-64.7	57.6	139.8	-.3	-30	.3	-.5
Scenario II: Sliding surcharge foreign retaliation	-87.4	-49.5	-37.9	70.5	-.4	-40	.7	-1.0
Scenario III: Sliding surcharge Canada and LDCs exempt	.4	-28.3	28.7	66.3	-.3	-10	.1	-.1
Scenario IV: Sliding surcharge Japan only	-.1	-14.1	14.2	27.8	-.1	-5	.1	-.1
Scenario V: Sliding surcharge dollar appreciation	-84.5	-138.2	53.7	122.0	-.2	-50	.3	-1.3
Scenario VI: Sliding surcharge dollar depreciation interest rate decline	98.6	120.4	-21.8	365.1	+1.5	-180	-.9	-.4
Scenario VII: Sliding surcharge dollar depreciation interest rate increase	67.3	-85.4	152.7	-72.0	-2.5	+200	1.3	1.9

Note: All data are presented in changes from the baseline. Columns (1) to (5) report cumulated deviations; columns (6) to (7) report average deviations, and in the last column consumer price changes are reported for the final year. Changes in exports, imports, trade balance, and the budget are measured in billions of U.S. dollars. Changes in GNP and consumer prices are calculated as percentage deviations. Changes in interest rates and the unemployment rate are measured as deviations in basis points and percentage points, respectively.

U.S. Import Surcharge, 20%, 15%, 7%
Real Gross National Product.

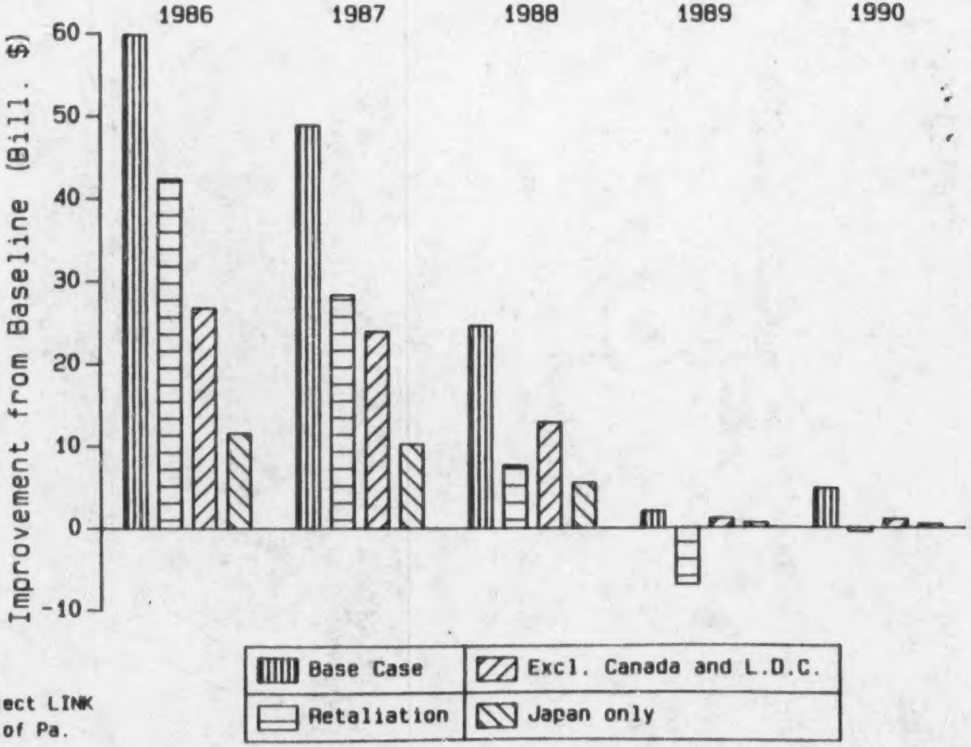


U.S. Import Surcharge, 20%, 15%, 7%
Current Account.



Project LINK
U. of Pa.

U.S. Import Surcharge, 20%, 15%, 7%
Federal Budget Deficit.



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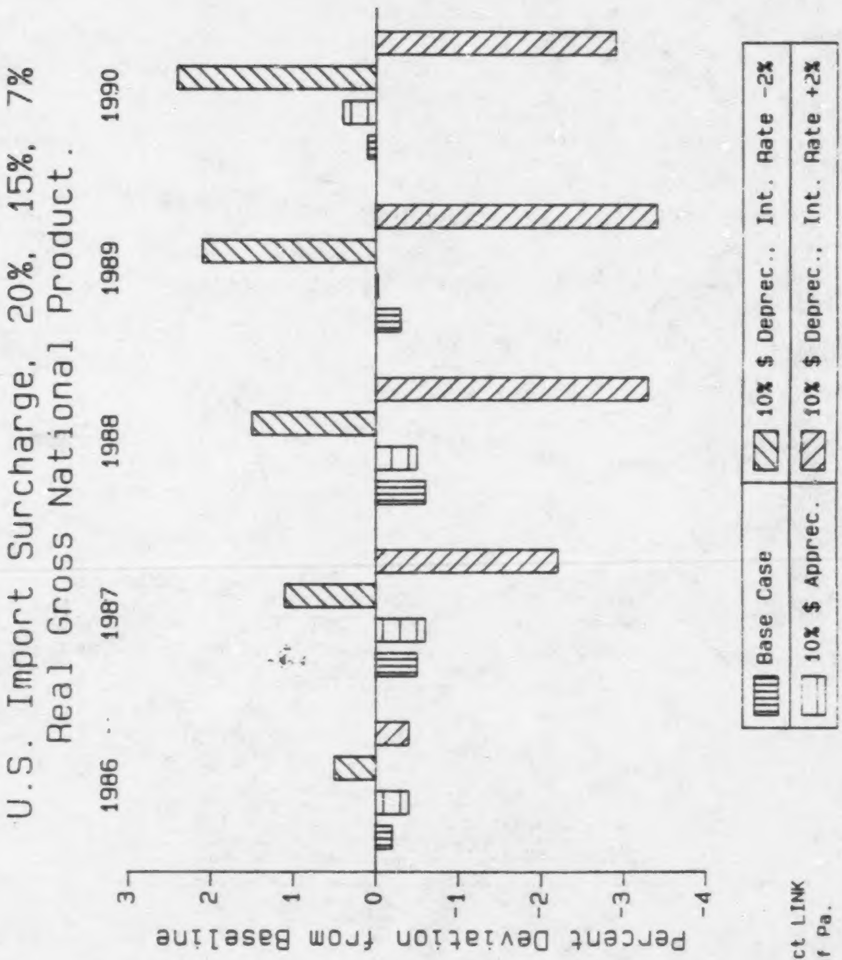
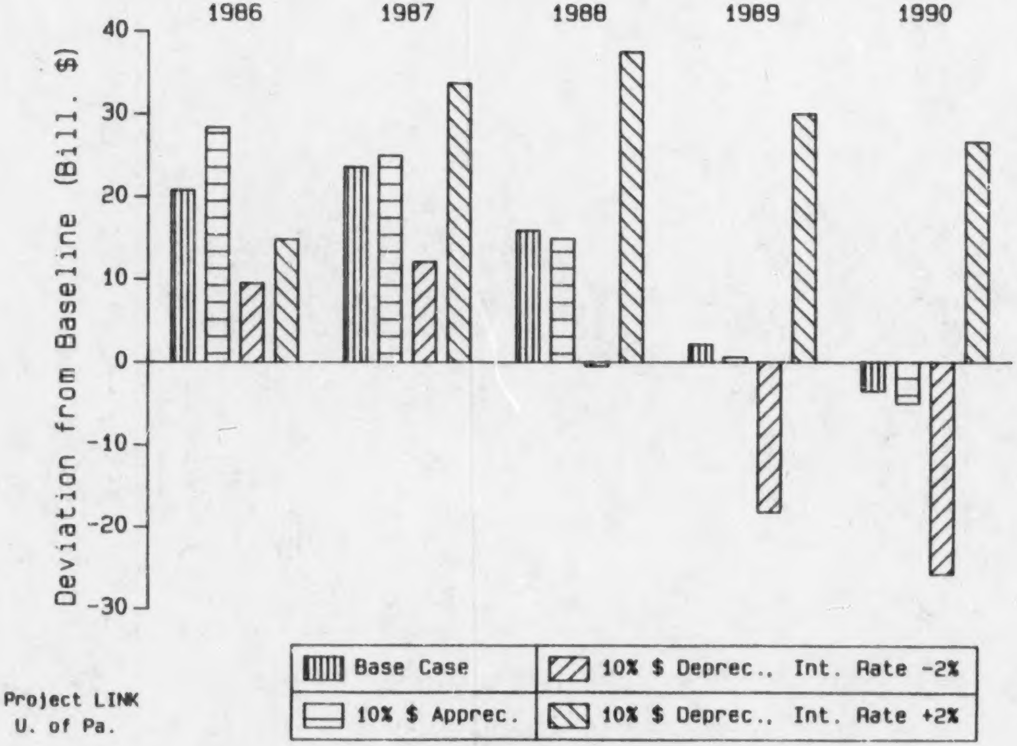


U.S. Import Surcharge, 20%, 15%, 7%
Real Gross National Product.

Project LINK
U. of Pa.

U.S. Import Surcharge, 20%, 15%, 7%
Current Account.



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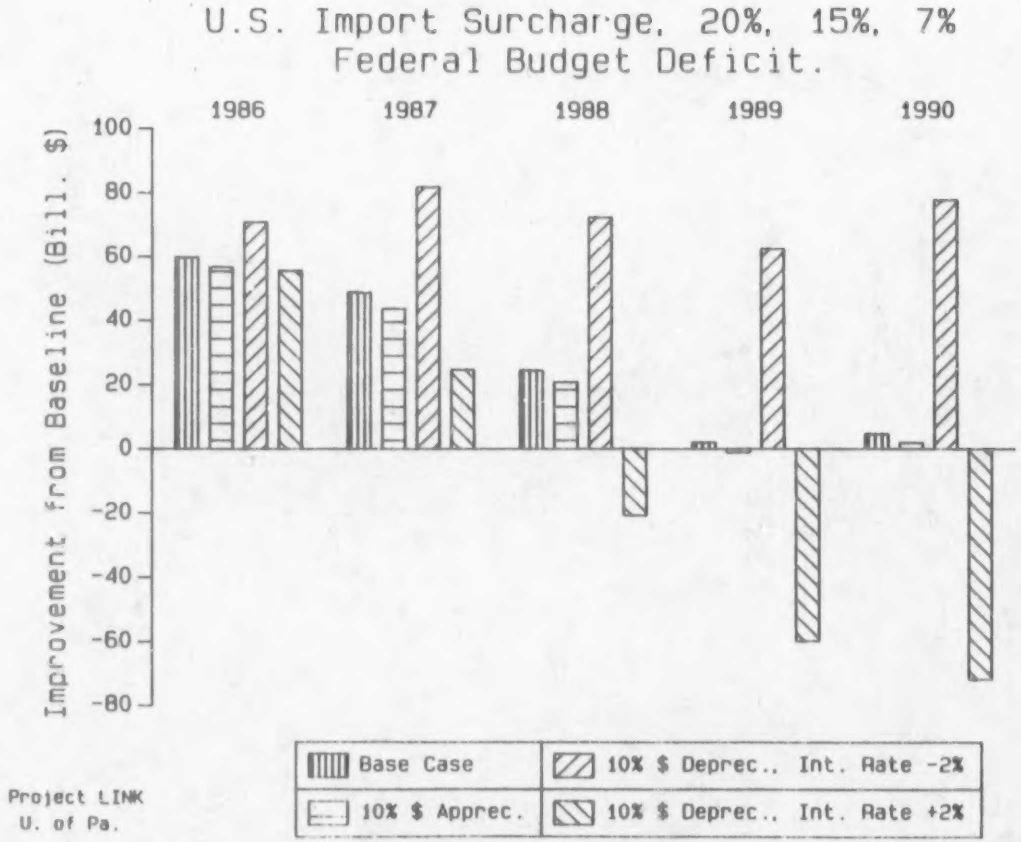
U.S. Import Surcharge, 20%, 15%, 7%
Federal Budget Deficit.
1986
1987
1988
1989
1990
Improvement from Baseline (Bill. $)
100
80
60
40
20
0
-20
-40
-60
-80
Base Case
10% $ Apprec.
10% $ Deprec., Int. Rate -2%
10% $ Deprec., Int. Rate +2%
Project LINK
U. of Pa.

expected. While a surcharge will be inflationary in the short and medium term, the recessionary effects on wage and price increases potentially more than compensate the initial inflationary effect.

A closer look at the final three scenario results reveals the crucial importance of the exchange rate response to a surcharge. Compared with the base case in Scenario I, the additional exchange rate reaction can induce a wide range of variation. Should the surcharge be accompanied by an appreciation of the effective dollar rate, short-and medium term effects on trade balance and government budget, as well as effects on real activity, would be only slightly altered; the inflationary effect could be expected to be less pronounced in in the short run and ever more favorable in the long run due to lower import price increases. For both cases involving an exchange rate depreciation caused by either a loss in confidence in the U.S. economy or an interest rate-induced capital outflow, the differences are even more striking. In the soft-landing scenario, the negative impact on activity of a surcharge would be more than compensated for by the stimulating effects of easier monetary policy and the resulting depreciation. Higher economic activity would improve the Federal budget even further, while the trade balance effect would be smaller, caused by induced imports. Contrary to that, in the hard-landing scenario, the interest rate increase, caused by a shortage of funds following a capital outflow, will — both in the short- and medium-term -- slow down economic activity. In addition, it will be inflationary. The loss in real activity will ultimately lead to a further deterioration of the Federal budget situation.

4.2 Effects on the World Economy

~~The~~ response of major aggregate indicators of world activity is reported in Tables 9 and 10; in addition, individual country results for Japan can be found in Tables A.8 - A.14 in the appendix.

In general, the first year responses are in accord with accepted economic theory. The imposition of a surcharge, under any policy and/or exchange rate response, reduces world trade. The reduction is most pronounced when there is full retaliation, or when the secondary effects of an induced recession in the U.S. (scenario VII) generate a further decline in trade activities. The effects on GNP growth in the OECD area range from 1/10 to 7/10 of a percent in the first year. Compared with a baseline forecast of about 3 percent growth in 1986, the worst case represents indeed a substantial reduction in economic activity. While a multilateral tariff is clearly inflationary (scenario II), this effect would be greatly reduced in the case of a dollar depreciation, due to lower import prices in the majority of OECD countries. With the exception of scenario III (and partly, IV), where the LDCs gain from trade substitution, the primary and secondary effects of a U.S. surcharge will tend to reduce LDC growth slightly. The reduction is, however, relatively small and a major effect on the debt status of certain countries can only be expected in the case of scenario VII, where the U.S. interest rate increase is expected to be reflected fully in LIBOR.

Over the 5-year horizon of our simulations, the effects are, on average, much less pronounced. As is the case for the U.S., the initial recessionary effect of a surcharge tends to improve growth rates in the medium-term. An inventory cycle, combined with adjustments in domestic spending, ultimately reverse the initial GNP losses. Average growth rates over the simulation period are affected only marginally; simiarly, reduced inflation in the medium-term compensates for initial tariff-related increases.

Table 9

Comparion of First Year Effects Under Various Import Surcharge Scenarios

Scenario	World Trade (%)	OECD GNP Growth (%)	OECD Inflation (%)	LDC GNP Growth (%)
Scenario I: Sliding surcharge	-1.1	-.2	.3	-.1
Scenario II: Sliding surcharge foreign retaliation	-1.6	-.3	.7	-.1
Scenario III: Sliding surcharge Canada and Deve exempt	-.4	-.1	.2	.2
Scenario IV: Sliding surcharge Japan only	.1	-.1	.1	.1
Scenario V: Sliding surcharge dollar appreciation	-.9	0	.1	-.1
Scenario VI: Sliding surcharge dollar depreciation interest rate decline	-1.0	-.2	-.2	-.1
Scenario VII: Sliding surcharge dollar depreciation interest rate increase	-1.4	-.7	0	-.3

Note: All data are presented as percentage changes from the baseline.

Table 10

Comparison of Five-Year Effects Under Various Import Surcharge Scenarios

Scenario	World Trade (%)	OECD GNP Growth (%)	OECD Inflation (%)	LDC GNP Growth (%)
Scenario I: Sliding surcharge	-.1	0	-.1	0
Scenario II: Sliding surcharge foreign retaliation	-.1	0	-.1	0
Scenario III: Sliding surcharge Canada and LDCs exempt	-.05	0	-.1	0
Scenario IV: Sliding surcharge Japan only	0	0	0	0
Scenario V: Sliding surcharge dollar appreciation	-.1	.1	.2	.1
Scenario VI: Sliding surcharge dollar depreciation interest rate decline	.05	.2	-.4	0
Scenario VII: Sliding surcharge dollar depreciation interest rate increase	-.2	-.4	-.3	-.2

Note: All data are presented as changes from the baseline. World trade is reported as percentage deviation. OECD and LDC GNP and OECD inflation are reported as deviations of average growth rate over 5-year period.

On an aggregate level, long run effects on world activity, trade, and inflation do basically occur only in the hard-landing scenario. In that case, the interest rate increase is responsible for a persistent reduction in activity.

5. Summary

It has been the purpose of this paper to examine the potential effects of a temporary import surcharge on the U.S. economy and the world as a whole under various scenarios. In all these simulations, such a surcharge turns out to reduce the trade deficit and generate Federal revenues, as expected. The initial effects on domestic activity, world trade and world GNP are also unambiguously negative. In the medium term, the effects are, however, rather diverse, depending upon the adjustment of other policy variables, market expectations, and exchange rates. In the long-run, with favorable exchange rate adjustments, a surcharge may improve GNP in the U.S. while reducing the Federal deficit substantially. The hard-landing scenario, on the other hand, portrays a surcharge as generating significant GNP losses combined with a deterioration of the Federal budget situation. Also, retaliatory actions from trading partners would, in all scenarios, reduce the effectiveness of a surcharge appreciably. In that case, the revenue effect would be reduced to almost half of its original size, while the trade balance effect would even be reversed; GNP losses would end up being substantially higher without the benefit of more than just a marginal reduction in the inflationary effect.

Macro effects are examined in this analysis. Individual sectors or industries may gain at the expense of others. At the world level, some countries may gain at the expense of others, but the United States does not appear to be a gainer.

APPENDIX

Tables A.1 - A.7

UNITED STATES

Tables A.8 - A.14

JAPAN

Table A.1

```
                                               US
US TARIFF, 86 20%, 87 15%, 88 7%                                                              PROJECT LINK  FRI APR    5  14 34 13
-------------------------------------------------------------------------------------------------------------------------------------
                              AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION 136 CE$        0.00      7.06  0.3      8.08  0.3      0.71  0.0     -7.86 -0.2    -12.88 -0.4
PUBL CONSUMPTION 206 GVPT$    0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
FEDERAL EXP      203 GVPF$    0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
DEFENSE EXP      204 GVPFD$   0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
PRIV INVESTMENT  194 IBI$       0.00     -1.87 -0.3     -5.61 -0.7    -12.22 -1.4     -4.95 -0.5     -2.29 -0.2
INVENTORY CHANGE 195 IBII$      0.00    -11.63 -40.5    -6.79 -28.5    -0.30 -1.8      6.49 20.3      4.43 11.1
EXPORT GOOD+SERV1572 IFB$      0.000    -0.667  0.2    -3.389 -0.7    -5.997 -1.2    -6.029 -1.2    -6.021 -0.9
IMPORT GOOD+SERV1531 IMB$      0.000    55.509 10.5    34.947  6.1    10.021  1.7    -8.946 -1.2    -2.522 -0.3
GROSS NATL PROD  230 GNP$       0.00    -50.99 -1.2    -35.86 -0.8    -28.32 -0.6    -10.70 -0.2    -18.67 -0.3
-------------------------------------------------------------------------------------------------------------------------------------
                              AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, 1972 PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION  49 CE        0.000    -3.785 -0.3    -7.270 -0.6    -6.555 -0.5    -3.258 -0.3     1.386  0.1
 - DURABLES       58 CED      0.0000   -0.6159 -0.3   -0.9003 -0.4   -0.4564 -0.2    0.4788  0.2    1.9648  0.9
 - NON DURABLES  123 CEN       0.000    -2.243 -0.5    -4.892 -1.2    -4.916 -1.1    -3.250 -0.7    -0.989 -0.2
 - SERVICES       38 CES       0.000    -0.926 -0.2    -1.477 -0.3    -1.182 -0.2    -0.487 -0.1     0.410  0.1
PUBL CONSUMPTION  47 GVPT      0.000    -0.595 -0.2    -1.156 -0.3    -0.778 -0.2    -0.041  0.0     0.905  0.3
FEDERAL EXP      211 GVPF     0.0000   -0.2868 -0.2   -0.5638 -0.4   -0.3549 -0.2    0.0061  0.0    0.4247  0.3
DEFENSE EXP      208 GVPFD    0.0000   -0.2414 -0.2   -0.4831 -0.5   -0.3087 -0.3    0.0060  0.0    0.3823  0.3
NON-RES INVEST    48 IBFN      0.000    -1.525 -0.6    -4.535 -1.7    -6.066 -2.2    -3.499 -1.2    -0.480 -0.2
RESIDENTIAL INVT  28 IHFR      0.000     3.098  4.9     1.626  2.5    -1.114 -1.7    -1.399 -2.1    -0.569 -0.8
INVENTORY CHANGE  39 IBII      0.000    -5.531 -41.0   -3.476 -31.5   -0.545 -6.5     2.674 19.8     1.892 11.4
EXPORT GOOD+SERV1573 IFB       0.000    -2.286 -1.4    -4.607 -2.7    -4.355 -2.4    -2.627 -1.4    -1.048 -0.5
IMPORT GOOD+SERV1532 IMB        0.00     -7.61 -4.0    -10.07 -5.1     -7.71 -3.7     -2.74 -1.2      0.03  0.0
GROSS NATL PROD   36 GNP        0.00     -3.01 -0.2     -9.34 -0.5    -11.70 -0.6     -5.41 -0.3      2.05  0.1
-------------------------------------------------------------------------------------------------------------------------------------
                              BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
EXPORTS SITC 0-1 601 VXL01    0.0000   -0.0998 -0.3   -0.2901 -0.7   -0.3428 -0.7   -0.3053 -0.5   -0.2420 -0.4
        SITC 2+4 602 VXL24    0.0000    0.2420  0.6    0.4455  1.5    0.2159  0.7   -0.1702 -0.5   -0.3329 -0.9
        SITC 3   603 VXL3     0.0000   -0.0209 -0.2   -0.0416 -0.3   -0.0531 -0.4   -0.0476 -0.3   -0.0364 -0.2
        SITC 5-9 604 VXL59     0.000    -0.009  0.0    -1.071 -0.6    -1.771 -0.8    -1.851 -0.8    -1.450 -0.5
       ALL GOODS 605 VXL09     0.000     0.113  0.0    -0.957 -0.3    -1.952 -0.6    -2.374 -0.7    -2.061 -0.5
IMPORTS SITC 0-1 614 VML01     0.000    -3.298 -11.4   -3.031 -9.8    -1.797 -5.1    -0.226 -0.6    -0.242 -0.6
        SITC 2+4 615 VML24    0.0000   -0.4053 -3.3   -0.2941 -2.2   -0.1659 -1.2    0.0002  0.0   -0.0046  0.0
        SITC 3   616 VML3      0.000    -1.996 -3.2    -2.220 -3.2    -1.990 -2.6    -0.973 -1.2    -0.105 -0.1
        SITC 5-9 624 VML59      0.00    -10.64 -3.8    -15.55 -5.1    -13.46 -4.0     -6.49 -1.7     -1.67 -0.4
       ALL GOODS 625 VML09      0.00    -16.34 -4.2    -21.10 -5.1    -17.42 -3.7     -7.69 -1.5     -2.03 -0.4
FOB TRADE BAL    644 TBL       0.000    16.456 -12.2   20.139 -14.2   15.466 -9.7     5.313 -3.1    -0.035  0.0
CURRENT ACCOUNT 1435 TBPCABOP  0.000    20.793 -15.3   23.632 -16.3   15.906 -9.8     2.117 -1.2    -3.499  1.8
AVG EXCH RATE   1446 REXAV75W 0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
-------------------------------------------------------------------------------------------------------------------------------------
                                                 KEY ECONOMIC INDICATORS
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
GNP DEFLATOR      74 PDGNP     0.000    -2.519 -1.1    -0.694 -0.3     0.127  0.0     0.215  0.1    -1.238 -0.4
PRIV CONS DEFL     4 PDCE      0.000     1.417  0.6     2.245  0.9     1.473  0.6     0.071  0.0    -1.320 -0.5
EXP GOODS DEFL  1570 PDIEBGTE  0.000     7.130  2.6    10.116  3.5     6.291  2.1     0.913  0.3    -1.331 -0.4
IMP GOODS DEFL  1529 PDIMBGTE  0.000    58.151 20.2    46.759 15.2    22.927  7.0    -0.937 -0.3    -1.198 -0.3
WAGE RATE INDEX  378 WRCMF$   0.0000    0.0497  0.3    0.1267  0.8    0.1053  0.6    0.0193  0.1   -0.0847 -0.5
UNEMPLOYMENT(%)    9 NRUI     0.0000    0.1732  2.4    0.3762  5.3    0.4083  6.2    0.2692  4.2    0.0282  0.4
CAPACITY UTIL(%)  89 CUMIP    0.0000   -0.0997 -0.1   -0.3640 -0.4   -0.3746 -0.4    0.0665  0.1    0.5921  0.7
FED FUNDS RATE   433 FRMFF    0.0000   -0.5254 -7.0   -0.4334 -4.8   -0.4379 -4.5   -0.3277 -3.5   -0.4649 -5.2
PRIME RATE       671 FRMPRIME 0.0000   -0.3963 -4.1   -0.3109 -2.8   -0.2941 -2.5   -0.2303 -2.0   -0.3219 -2.8
TREAS BILL RATE  111 FRMTB3MY 0.0000   -0.4036 -4.9   -0.2642 -2.8   -0.2578 -2.6   -0.1966 -2.1   -0.3009 -3.3
UNBORROWED RES B 241 FRENS+   0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
MONEY SUPPLY M1B 355 FM1B$     0.000    -0.106  0.0    -1.651 -0.3    -1.762 -0.3    -1.055 -0.1    -1.062 -0.1
FED GOV S/D      112 GVSURPF$  0.000    59.811 -29.9   48.763 -23.0   24.515 -11.3    2.037 -0.9     4.686 -2.3
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Table A.2

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                                                 US
US TARIFF WITH RETALIATION                                                                 PROJECT LINK  FRI APR   5  18:54:33
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                                      AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                    1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION 136 CE$              0.00      3.60  0.1      1.76  0.1     -6.28 -0.2    -13.13 -0.4    -15.62 -0.4
PUBL CONSUMPTION 206 GVPT$          0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
FEDERAL EXP      203 GVPF$          0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
DEFENSE EXP      204 GVPFD$         0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
PRIV INVESTMENT  194 IBT$             0.00     -9.11 -1.2    -12.58 -1.5    -19.20 -2.2     -9.73 -1.0     -6.20 -0.6
INVENTORY CHANGE 195 IBIT$            0.00    -13.74 -47.9    -8.55 -35.9    -1.42 -8.4      6.85 21.5      4.83 12.1
EXPORT GOOD+SERV1572 TEB$             0.00    -32.86 -7.9    -34.78 -7.6    -27.38 -5.4    -14.70 -2.6    -11.85 -1.9
IMPORT GOOD+SERV1531 TMB$            0.000    53.329 10.1    33.583  5.8    12.845  2.0    -4.611 -0.6     2.094  0.3
GROSS NATL PROD  238 GNP$             0.00    -91.69 -2.2    -79.18 -1.8    -65.70 -1.4    -32.96 -0.6    -35.84 -0.6
------------------------------------------------------------------------------------------------------------------------------
                                      AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, 1972 PRICES)
                                    1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION  49 CE              0.000    -4.387 -0.4    -5.661 -0.5    -1.813 -0.2     3.358  0.3     7.525  0.6
  - DURABLES      58 CED            0.0000   -0.6478 -0.3   -0.1726 -0.1    1.1690  0.6    2.5038  1.1    3.0885  1.6
  - NON DURABLES 123 CEN             0.000    -2.986 -0.7    -5.179 -1.2    -3.814 -0.9    -0.871 -0.2     1.657  0.4
  - SERVICES      38 CES            0.0000   -0.7537 -0.1   -0.3093 -0.1    0.8311  0.2    1.7246  0.3    2.1709  0.4
PUBL CONSUMPTION  47 GVPT           0.0000   -0.3977 -0.1   -0.4490 -0.1    0.4197  0.1    1.3003  0.4    1.9624  0.5
FEDERAL EXP      211 GVPF           0.0000   -0.2045 -0.2   -0.2515 -0.2    0.1666  0.1    0.5000  0.4    0.8740  0.6
DEFENSE EXP      208 GVPFD          0.0000   -0.1721 -0.2   -0.2151 -0.2    0.1459  0.1    0.5223  0.5    0.7870  0.7
NON RES INVEST.   48 IBFN            0.000    -4.239 -1.0    -6.874 -2.0    -7.000 -2.6    -2.932 -1.0     0.410  0.1
RESIDENTIAL INVT  28 IBFR           0.0000    3.9545  6.2    3.3740  5.2    0.0000  0.1   -0.9871 -1.5   -0.7112 -1.0
INVENTORY CHANGE  39 IBIT            0.000    -6.409 -48.1   -4.299 -38.9   -1.102 -13.1    2.776 20.5     2.020 12.2
EXPORT GOOD+SERV1573 TEB              0.00    -13.79 -8.7    -15.19 -9.0    -11.10 -6.2     -4.79 -2.5     -2.40 -1.2
IMPORT GOOD+SERV1532 TMB              0.00    -10.19 -5.3    -12.81 -6.4     -9.26 -4.4     -2.62 -1.2      0.63  0.3
GROSS NATL PROD   36 GNP              0.00    -15.16 -0.9    -16.29 -0.9    -11.42 -0.6      1.35  0.1      6.11  0.4
------------------------------------------------------------------------------------------------------------------------------
                                  BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                    1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
EXPORTS SITC 0-1 601 VXL01           0.000    -4.843 -12.6   -4.725 -10.9   -2.840 -5.7    -0.371 -0.7    -0.109 -0.2
        SITC 2+4 602 VXL24           0.000    -3.176 -10.8   -2.209 -7.6    -1.179 -3.6    -0.284 -0.8    -0.338 -0.9
        SITC 3   603 VXL3            0.000    -1.918 -13.9   -1.519 -11.0   -0.857 -5.8    -0.071 -0.4    -0.063 -0.4
        SITC 5-9 604 VXL59            0.00    -21.82 -12.9   -21.02 -11.2   -13.27 -6.3     -3.76 -1.6     -2.83 -1.1
       ALL GOODS 605 VXL09            0.00    -31.75 -12.7   -29.56 -10.7   -18.15 -5.9     -4.48 -1.3     -3.34 -0.9
IMPORTS SITC 0-1 614 VML01           0.000    -3.287 -11.4   -3.065 -9.9    -1.838 -5.2    -0.293 -0.8    -0.321 -0.8
        SITC 2+4 615 VML24          0.0000    0.4749 -3.9   -0.2292 -1.7    0.0598  0.4    0.2655  1.6    0.1820  1.0
        SITC 3   616 VML3            0.000    -0.811 -1.3    -1.056 -1.5    -0.847 -1.1     0.049  0.1     1.167  1.3
        SITC 5-9 624 VML59            0.00    -10.43 -3.7    -14.68 -4.8    -11.18 -3.3     -3.63 -1.0      0.80  0.2
       ALL GOODS 625 VML09            0.00    -15.00 -3.9    -19.03 -4.6    -13.72 -2.9     -3.60 -0.7      1.82  0.3
FOB TRADE BAL    644 TBL              0.00    -16.75 12.4    -10.52  7.4     -4.42  2.0     -0.80  0.5     -5.10  2.7
CURRENT ACCOUNT 1435 TBPCABOP         0.00     -8.94  6.6     -6.00  4.2     -7.23  4.5    -10.09  5.6    -13.95  7.1
AVG EXCH RATE   1446 REXAV75W       0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
------------------------------------------------------------------------------------------------------------------------------
                                                  KEY ECONOMIC INDICATORS
                                    1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
GNP DEFLATOR      74 PDGNP           0.000    -3.209 -1.3    -2.149 -0.9    -1.947 -0.7    -1.913 -0.7    -2.974 -1.0
PRIV CONS DEFL     4 PDCE            0.000     1.238  0.5     1.354  0.6    -0.135 -0.1    -1.792 -0.7    -2.800 -1.0
EXP GOODS DEFL  1570 PDTEBGTE        0.000     8.196  3.0    11.561  4.0     7.270  2.4     1.287  0.4    -1.248 -0.4
IMP GOODS DEFL  1529 PDTMBGTE        0.000    62.018 21.6    51.005 16.6    26.923  8.2     1.314  0.4     0.426  0.1
WAGE RATE INDEX  370 WRCMF$         0.0000    0.0395  0.3    0.0725  0.5   -0.0051  0.0   -0.1346 -0.8   -0.2371 -1.3
UNEMPLOYMENT(%)    9 MRUI           0.0000    0.5112  7.0    0.9519 13.4    0.7730 11.0    0.2555  3.9   -0.2304 -3.0
CAPACITY UTIL(%)  89 CUMIP           0.000    -1.001 -1.2    -1.492 -1.0    -0.957 -1.1     0.209  0.2     1.037  1.2
FED FUNDS RATE   433 FRMFF          0.0000   -0.8536 -11.3  -0.7119 -7.8   -0.6305 -6.5   -0.3944 -4.2   -0.5195 -5.8
PRIME RATE       671 FRMPRIME       0.0000   -0.6482 -6.6   -0.5230 -4.7   -0.4256 -3.6   -0.2764 -2.4   -0.3572 -3.1
TREAS BILL RATE  111 FRMTB3MY       0.0000   -0.6597 -8.0   -0.4453 -4.7   -0.3710 -3.8   -0.2342 -2.5   -0.3395 -3.7
UNBORROWED RES B 241 FREN$+         0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
MONEY SUPPLY M1B 355 FM1B$           0.000    -0.156  0.0    -2.633 -0.4    -2.675 -0.4    -1.250 -0.2    -0.844 -0.1
FED GOV S/D      112 GVSURPF$        0.000    42.294 -21.2   28.100 -13.3    7.464 -3.5    -6.939  3.2    -0.512  0.2
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Table A.3

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                                                             US
US TARIFF EXCL. CANADA AND LDC                                                           PROJECT LINK  TUE APR   9  17:48:43
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                                AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION 136 CE$         0.000     3.947  0.1     6.386  0.2     3.036  0.1    -2.343 -0.1    -6.451 -0.2
PUBL CONSUMPTION 206 GVPT$      0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
FEDERAL EXP      203 GVPF$      0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
DEFENSE EXP      204 GVPFD$     0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
PRIV INVESTMENT  194 IBI$        0.000     4.787  0.7     1.064  0.1    -5.006 -0.6    -4.732 -0.5    -2.510 -0.2
INVENTORY CHANGE 195 IBIT$       0.000    -2.016 -7.0    -1.511 -6.3     0.042  0.2     1.259  3.9     1.200  3.2
EXPORT GOOD+SERV1572 TEB$        0.000     0.013  0.0    -0.661 -0.1    -1.849 -0.4    -2.361 -0.4    -2.297 -0.4
IMPORT GOOD+SERV1531 TMB$        0.000    27.252  5.1    16.980  2.9     4.361  0.7    -6.022 -0.8    -2.655 -0.3
GROSS NATL PROD  238 GNP$         0.00    -18.50 -0.4    -10.19 -0.2     -8.18 -0.2     -3.41 -0.1     -8.60 -0.2
--------------------------------------------------------------------------------------------------------------------------
                                 AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, 1972 PRICES)
                                1985-1    1986 1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION  49 CE          0.000    -1.845 -0.2    -4.371 -0.4    -4.833 -0.4    -3.545 -0.3    -0.759 -0.1
  - DURABLES      58 CED        0.0000   -0.3799 -0.2   -0.7032 -0.3   -0.6844 -0.3   -0.2929 -0.1    0.5764  0.3
  - NON DURABLES 123 CEN         0.000    -0.915 -0.2    -2.501 -0.6    -2.950 -0.7    -2.433 -0.5    -1.196 -0.3
  - SERVICES      30 CES         0.000    -0.551 -0.1    -1.167 -0.2    -1.198 -0.2    -0.819 -0.1    -0.140  0.0
PUBL CONSUMPTION  47 GVPT       0.0000   -0.3811 -0.1   -0.8774 -0.3   -0.8040 -0.2   -0.4084 -0.1    0.2310  0.1
FEDERAL EXP      211 GVPF       0.0000   -0.1799 -0.1   -0.4160 -0.3   -0.3591 -0.3   -0.1644 -0.1    0.1197  0.1
DEFENSE EXP      200 GVPFD      0.0000   -0.1514 -0.1   -0.3573 -0.3   -0.3127 -0.3   -0.1454 -0.1    0.1079  0.1
NON RES INVEST.   48 IBFN        0.000    -0.205 -0.1    -1.972 -0.8    -3.333 -1.2    -2.531 -0.9    -0.891 -0.3
RESIDENTIAL INVT  28 IBFR       0.0000    1.4301  2.2    0.5663  0.9   -0.8614 -1.3   -0.9155 -1.4   -0.3555 -0.5
INVENTORY CHANGE  39 IBIT       0.0000   -0.9636 -7.1   -0.7454 -6.8   -0.0334 -0.4    0.5305  3.9    0.5486  3.3
EXPORT GOOD+SERV1573 TEB         0.000    -0.225 -0.1    -0.963 -0.6    -1.274 -0.7    -1.032 -0.5    -0.499 -0.2
IMPORT GOOD+SERV1532 TMB         0.000    -3.392 -1.8    -4.881 -2.4    -4.068 -1.9    -1.836 -0.8    -0.380 -0.1
GROSS NATL PROD   36 GNP         0.000     1.202  0.1    -3.481 -0.2    -7.071 -0.4    -6.065 -0.3    -1.417 -0.1
--------------------------------------------------------------------------------------------------------------------------
                              BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                1985-1    1986-1 %CHG    1987-1 %CHG    1988 1 %CHG    1989-1 %CHG    1990-1 %CHG
EXPORTS SITC 0-1 601 VXL01      0.0000    0.1015  0.3    0.1058  0.2   -0.0585 -0.1   -0.1738 -0.3   -0.1901 -0.3
        SITC 2+4 602 VXL24      0.0000    0.1109  0.4    0.1109  0.4    0.0271  0.1   -0.0701 -0.2   -0.1197 -0.3
        SITC 3   603 VXL3       0.0000   -0.0074 -0.1   -0.0270 -0.2   -0.0356 -0.2   -0.0331 -0.2   -0.0252 -0.1
        SITC 5-9 604 VXL59      0.0000    0.9431  0.6    0.9796  0.5    0.0599  0.0   -0.6206 -0.3   -0.7460 -0.3
       ALL GOODS 605 VXL09       0.000     1.148  0.5     1.177  0.4    -0.007  0.0    -0.897 -0.3    -1.002 -0.3
IMPORTS SITC 0 1 614 VML01      0.0000   -0.6523 -2.3   -0.6934 -2.2   -0.4627 -1.3   -0.0928 -0.2   -0.1150 -0.3
        SITC 2+4 615 VML24      0.0000    0.0488  0.4    0.0503  0.4    0.0008  0.1    0.0010  0.0    0.0157  0.1
        SITC 3   616 VML3       0.0000    0.2794  0.4   -0.1556 -0.2   -0.6842 -0.9   -0.9118 -1.1   -0.4763 -0.5
        SITC 5-9 624 VML59       0.000    -4.024 -1.4    -7.303 -2.4    -7.202 -2.1    -4.366 -1.2    -1.640 -0.4
       ALL GOODS 625 VML09       0.000    -4.348 -1.1    -8.102 -1.9    -8.340 -1.8    -5.370 -1.0    -2.224 -0.4
FOB TRADE BAL    644 TBL        0.0000    5.4965 -4.1    9.2795 -6.5    8.3327 -5.2    4.4726 -2.6    1.1422 -0.6
CURRENT ACCOUNT 1435 TBPCABOP   0.0000    6.1376 -4.5    9.3370 -6.4    8.1272 -5.0    3.6612 -2.0    0.3574 -0.2
AVG EXCH RATE   1446 REXAV75W   0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
--------------------------------------------------------------------------------------------------------------------------
                                                 KEY ECONOMIC INDICATORS
                                1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
GNP DEFLATOR      74 PDGNP       0.000    -1.229 -0.5    -0.001  0.0     0.561  0.2     0.692  0.3    -0.229 -0.1
PRIV CONS DEFL     4 PDCE       0.0000    0.7342  0.3    1.4783  0.6    1.2942  0.5    0.5828  0.2   -0.3401 -0.1
EXP GOODS DEFL  1570 PDIEBGIE   0.0000    0.9592  0.3    1.5186  0.5    1.0171  0.3    0.1421  0.0   -0.3542 -0.1
IMP GOODS DEFL  1529 PDIMBGIF    0.000    27.163  9.4    22.002  7.2    10.001  3.3    -0.584 -0.2    -0.000 -0.2
WAGE RATE INDEX  578 WRCMF$     0.0000    0.0258  0.2    0.0822  0.5    0.0906  0.6    0.0551  0.3   -0.0072  0.0
UNEMPLOYMENT(%)    9 NRUI       0.0000    0.0131  0.2    0.0545  0.8    0.1297  2.0    0.1810  2.0    0.1330  2.1
CAPACITY UTIL(%)  88 CUMIP      0.0000    0.1489  0.2    0.1219  0.1   -0.0505 -0.1   -0.0720 -0.1    0.1190  0.1
FED FUNDS RATE   433 FRMFF      0.0000   -0.1923 -2.5   -0.1603 -1.9   -0.1799 -1.9   -0.1436 -1.5   -0.1983 -2.2
PRIME RATE       671 FRMPRIME   0.0000   -0.1353 -1.4   -0.1314 -1.2   -0.1341 -1.1   -0.1091 -0.9   -0.1337 -1.2
TREAS BILL RATE  111 FRMTB3MY   0.0000   -0.1387 -1.7   -0.1153 -1.2   -0.1178 -1.2   -0.0909 -1.0   -0.1220 -1.3
UNBORROWED RES B 241 FREN$+     0.0000    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0    0.0000  0.0
MONEY SUPPLY M1B 355 FM1B$      0.0000   -0.2527  0.0   -0.2583  0.0   -0.365  -0.1   -0.3127  0.0   -0.6100 -0.1
FED GOV S/D      112 GVSURPF$    0.000    26.715 -13.4   23.788 -11.2   12.694 -5.9     1.103 -0.5     1.025 -0.5
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Table A.4

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                                                       US
US TARIFF AGAINST JAPAN ONLY                                                                    PROJECT LINK  FRI APR   5  18:09:02
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                                     AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                      1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION 136 CE$              0.000     1.626   0.1     2.764   0.1     1.238   0.0    -1.245   0.0    -3.189  -0.1
PUBL CONSUMPTION 206 GVPT$            0.0000    0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0
FEDERAL EXP      203 GVPF$            0.0000    0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0
DEFENSE EXP      204 GVPFD$           0.0000    0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0
PRIV INVESTMENT  194 IBI$             0.000     2.664   0.4     0.737   0.1    -2.221  -0.3    -2.512  -0.3    -1.373  -0.1
INVENTORY CHANGE 195 IBII$            0.0000   -0.3535 -1.2    -0.4402 -1.8    -0.0181 -0.1     0.2612  0.8     0.4373  1.1
EXPORT GOOD+SERV1572 TFB$             0.0000    0.0586  0.0    -0.1934  0.0    -0.8208 -0.2    -0.9976 -0.2    -0.7473 -0.1
IMPORT GOOD+SERV1531 IMB$             0.000    11.293   2.1     6.097   1.2     1.309   0.2    -3.159  -0.4    -1.569  -0.2
GROSS NATL PROD  238 GNP$             0.000    -6.945  -0.2    -3.594  -0.1    -3.191  -0.1    -1.594   0.0    -3.742  -0.1
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                                     AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, 1972 PRICES)
                                      1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION  49 CE               0.000    -0.780  -0.1    -1.948  -0.2    -2.180  -0.2    -1.601  -0.1    -0.382   0.0
  - DURABLES      50 CED              0.0000   -0.1782 -0.1    -0.3337 -0.2    -0.3334 -0.2    -0.1526 -0.1     0.2459  0.1
  - NON DURABLES 123 CEN              0.000    -0.365  -0.1    -1.069  -0.3    -1.293  -0.3    -1.075  -0.2    -0.506  -0.1
  - SERVICES      38 CFS              0.0000   -0.2446  0.0    -0.5449 -0.1    -0.5600 -0.1    -0.3733 -0.1    -0.0422  0.0
PUBL CONSUMPTION  47 GVPT             0.0000   -0.1689 -0.1    -0.3977 -0.1    -0.3650 -0.1    -0.1770 -0.1     0.1235  0.0
FEDERAL EXP      211 GVPF             0.0000   -0.0793 -0.1    -0.1882 -0.1    -0.1620 -0.1    -0.0714  0.0     0.0618  0.0
DEFENSE EXP      208 GVPFD            0.0000   -0.0668 -0.1    -0.1613 -0.2    -0.1416 -0.1    -0.0831 -0.1     0.0554  0.0
NON-RES INVEST.   48 IBFN             0.000    -0.055   0.0    -0.842  -0.3    -1.471  -0.5    -1.150  -0.4    -0.398  -0.1
RESIDENTIAL INVT ,28 IBFR             0.0000    0.5648  0.9     0.1919  0.3    -0.3969 -0.6    -0.3852 -0.6    -0.1298 -0.2
INVENTORY CHANGE  39 IBIT             0.0000   -0.1606 -1.2    -0.1982 -1.8    -0.0071 -0.1     0.1143  0.8     0.1885  1.1
EXPORT GOOD+SERV1573 TEB              0.0000    0.0388  0.0    -0.2264 -0.1    -0.4670 -0.3    -0.4260 -0.2    -0.1605 -0.1
IMPORT GOOD+SERV1532 IMB              0.000    -1.253  -0.7    -1.914  -1.0    -1.627  -0.8    -0.716  -0.3    -0.013   0.0
GROSS NATL PROD   36 GNP              0.000     0.683   0.0    -1.506  -0.1    -3.268  -0.2    -2.919  -0.2    -0.666   0.0
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                                 BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                      1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
EXPORTS SITC 0-1 601 VXL01            0.0000   -0.0205 -0.1     0.0049  0.0    -0.0220  0.0    -0.0005  0.0     0.1264  0.2
        SITC 2+4 602 VXL24            0.0000    0.0362  0.1    -0.0026  0.0    -0.0499 -0.2    -0.0758 -0.2    -0.1075 -0.3
        SITC 3   603 VXL3             0.0000    0.0085  0.1    -0.0051  0.0    -0.0211 -0.1    -0.0358 -0.2    -0.0401 -0.2
        SITC 5-9 604 VXL59            0.0000    0.5238  0.3     0.5575  0.3    -0.0073  0.0    -0.4550 -0.2    -0.4905 -0.2
       ALL GOODS 605 VXL09            0.0000    0.5480  0.2     0.5547  0.2    -0.1003  0.0    -0.5669 -0.2    -0.5115 -0.1
IMPORTS SITC 0-1 614 VMI01            0.0000   -0.0724 -0.3    -0.0891 -0.3    -0.1125 -0.3    -0.1376 -0.4    -0.1585 -0.4
        SITC 2+4 615 VMI24            0.0000    0.0309  0.3     0.0232  0.2     0.0001  0.0    -0.0070  0.0     0.0040  0.0
        SITC 3   616 VMI3             0.0000    0.0302  0.0    -0.1508 -0.2    -0.3652 -0.5    -0.4403 -0.5    -0.2493 -0.3
        SITC 5-9 624 VML59            0.000    -2.202  -0.8    -3.436  -1.1    -3.439  -1.0    -2.309  -0.6    -1.007  -0.2
       ALL GOODS 625 VML09            0.000    -2.214  -0.8    -3.653  -0.9    -3.917  -0.8    -2.894  -0.6    -1.411  -0.2
FOB TRADE BAL    644 TBL              0.0000    2.7616 -2.0     4.2077 -3.0     3.8169 -2.4     2.3269 -1.3     0.8997 -0.5
CURRENT ACCOUNT 1435 IBPCABOP         0.0000    2.8690 -2.1     4.0742 -2.8     3.6808 -2.3     2.1612 -1.2     0.8217 -0.4
AVG EXCH RATE   1446 REXAV75W         0.0000    0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0
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                                                     KEY ECONOMIC INDICATORS
                                      1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
GNP DEFLATOR      74 PDGNP            0.0000   -0.4937 -0.2     0.0107  0.0     0.2986  0.1     0.3347  0.1    -0.0923  0.0
PRIV CONS DEFL     4 PDCE             0.0000    0.3077  0.1     0.6503  0.3     0.5732  0.2     0.2476  0.1    -0.1843 -0.1
EXP GOODS DEFL  1570 PDTFBGTE         0.0000    0.0562  0.0     0.1614  0.1     0.1387  0.0     0.0249  0.0    -0.0491  0.0
IMP GOODS DEFL  1529 PDTMBGTE         0.000    10.794   3.8     8.617   2.8     4.025   1.2    -0.779  -0.2    -0.845  -0.2
WAGE RATE INDEX  378 WRLMF$           0.0000    0.0180  0.1     0.0360  0.2     0.0403  0.2     0.0244  0.1    -0.0048  0.0
UNEMPLOYMENT(%)    9 NRUI             0.0000    0.0005  0.0     0.0154  0.2     0.0556  0.8     0.0883  1.4     0.0703  1.1
CAPACITY UTIL(%)  89 CUMIP            0.0000    0.0739  0.1     0.0665  0.1    -0.0273  0.0    -0.0565 -0.1     0.0264  0.0
FED FUNDS RATE   433 FRMFF            0.0000   -0.0729 -1.0    -0.0605 -0.8    -0.0759 -0.8    -0.0624 -0.7    -0.0827 -0.9
PRIME RATE       671 FRMPRIME         0.0000   -0.0494 -0.5    -0.0547 -0.5    -0.0579 -0.5    -0.0478 -0.4    -0.0549 -0.5
TREAS BILL RATE  111 FRMTB3MY         0.0000   -0.0508 -0.6    -0.0408 -0.5    -0.0510 -0.5    -0.0398 -0.4    -0.0498 -0.5
UNBORROWED RES B 241 FREN$*           0.0000    0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0     0.0000  0.0
MONEY SUPPLY M1B 355 FM1B$            0.0000   -0.1384  0.0    -0.0605  0.0    -0.1274  0.0    -0.1404  0.0    -0.2961  0.0
FED GOV S/D      112 GVSURPF$         0.000    11.495  -5.8    10.137  -4.8     5.364  -2.5     0.453  -0.2     0.413  -0.2
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Table A.5

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US TARIFF AND 10% DOLLAR APPRECIATION                    US                          PROJECT LINK  TUE APR    9  14 57 04
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                              AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION 136 CF$        0.00      2.73   0.1     -0.22   0.0     -8.75  -0.3    -17.60  -0.5    -22.91  -0.6
PUBL CONSUMPTION 206 GVPT$    0.0000    0.0000   0.0    0.0000   0.0    0.0000   0.0    0.0000   0.0    0.0000   0.0
FEDERAL EXP      203 GVPF$    0.0000    0.0000   0.0    0.0000   0.0    0.0000   0.0    0.0000   0.0    0.0000   0.0
DEFENSE EXP      204 GVPFD$   0.0000    0.0000   0.0    0.0000   0.0    0.0000   0.0    0.0000   0.0    0.0000   0.0
PRIV INVESTMENT  194 IBI$       0.00     -5.01  -0.7     -7.87  -1.0    -12.20  -1.4     -7.96  -0.8     -7.62  -0.7
INVENTORY CHANGE 195 IBII$     0.000    -8.753 -30.5    -4.542 -19.0     1.191   7.1     6.630  20.8     3.400   8.5
EXPORT GOOD+SERV1572 TEB$       0.00    -10.82  -2.6    -17.40  -3.0    -20.71  -4.1    -22.00  -3.9    -21.77  -3.4
IMPORT GOOD+SERV1531 TMB$       0.00     34.21   6.4     17.24   3.0     -3.84  -0.6    -22.67  -3.2    -16.79  -2.1
GROSS NATL PROD  238 GNP$       0.00     47.31  -1.1    -42.73  -0.9    -37.00  -0.8    -25.06  -0.5    -35.51  -0.8
----------------------------------------------------------------------------------------------------------------------------
                              AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, 1972 PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION  49 CE        0.000    -2.777  -0.2    -4.095  -0.4    -1.311  -0.1     3.689   0.3     8.810   0.7
  - DURABLES      58 CED      0.0000   -0.4327  -0.2   -0.2530  -0.1    0.7352   0.4    2.1168   1.0    3.6370   1.6
  - NON DURABLES 123 CEN       0.000    -1.791  -0.4    -3.390  -0.8    -2.493  -0.6    -0.090   0.0     2.411   0.5
  - SERVICES      38 CES      0.0000   -0.5544  -0.1   -0.4507  -0.1    0.4485   0.1    1.0616   0.3    2.7615   0.5
PUBL CONSUMPTION  47 GVPT     0.0000   -0.2878  -0.1   -0.3167  -0.1    0.4277   0.1    1.4446   0.4    2.4285   0.7
FEDERAL EXP      211 GVPF     0.0000   -0.1441  -0.1   -0.1714  -0.1    0.1785   0.1    0.8394   0.4    1.0540   0.7
DEFENSE EXP      208 GVPFD    0.0000   -0.1213  -0.1   -0.1465  -0.1    0.1563   0.1    0.5679   0.5    0.9485   0.8
NON-RES INVEST    48 IBFN      0.000    -2.116  -0.9    -4.177  -1.6    -4.427  -1.6    -1.605  -0.6     1.399   0.5
RESIDENTIAL INVT  28 IBFR     0.0000    2.2213   3.5    1.6484   2.5   -0.1226  -0.2   -0.3510  -0.5    0.4280   0.6
INVENTORY CHANGE  39 IBIT      0.000    -4.193 -31.1    -2.385 -21.6     0.247   2.9     2.861  21.2     1.581   9.6
EXPORT GOOD+SERV1573 TEB       0.000    -5.226  -3.3    -8.064  -4.0    -7.742  -4.3    -5.914  -3.1    -4.307  -2.1
IMPORT GOOD+SERV1532 TMB       0.000    -5.820  -3.0    -7.281  -3.7    -4.475  -2.1     0.554   0.2     3.251   1.3
GROSS NATL PROD   36 GNP        0.00     -6.56  -0.4    -10.11  -0.6     -8.45  -0.5     -0.43   0.0      7.09   0.4
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                           BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
EXPORTS SITC 0-1 601 VXL01     0.000    -1.389  -3.6    -1.817  -4.2    -1.744  -3.5    -1.684  -3.0    -1.559  -2.5
        SITC 2+4 602 VXL24     0.000    -1.203  -4.1    -1.469  -4.9    -1.802  -5.6    -2.277  -6.6    -2.723  -7.5
        SITC 3   603 VXL3     0.0000   -0.3353  -2.4   -0.3740  -2.7   -0.4224  -2.8   -0.4337  -2.7   -0.4432  -2.6
        SITC 5-9 604 VXL59      0.00     -8.90  -5.3    -12.94  -6.9    -13.83  -6.6    -14.65  -6.2    -14.54  -5.4
       ALL GOODS 605 VXL09      0.00    -11.83  -4.7    -16.60  -6.0    -17.79  -5.0    -19.05  -5.5    -19.26  -5.0
IMPORTS SITC 0-1 614 VML01     0.000    -3.642 -12.6    -3.357 -10.0    -2.206  -6.3    -0.743  -1.9    -0.700  -1.8
        SITC 2+4 615 VML24    0.0000   -0.9311  -7.6   -0.8100  -6.1   -0.5850  -4.1   -0.4210  -2.6   -0.4303  -2.4
        SITC 3   616 VML3      0.000    -4.274  -6.8    -4.498  -6.6    -4.263  -5.5    -3.180  -3.8    -2.377  -2.6
        SITC 5-9 624 VML59      0.00    -24.60  -8.0    -27.36  -9.0    -23.99  -7.1    -17.03  -4.5    -12.74  -3.0
       ALL GOODS 625 VML09      0.00    -33.53  -8.7    -36.02  -8.6    -31.05  -6.7    -21.38  -4.1    -16.33  -2.8
FOB TRADE BAL    644 TBL       0.000    21.697 -16.1    19.428 -13.7    13.252  -8.3     2.338  -1.3    -2.937   1.5
CURRENT ACCOUNT 1435 TBPCABOP  0.000    28.365 -20.9    24.994 -17.2    14.858  -9.2     0.582  -0.3    -4.986   2.5
AVG EXCH RATE   1446 REXAV75W  0.000    -7.675  -9.1    -8.094  -9.1    -8.132  -9.1    -8.157  -9.1    -8.154  -9.1
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                                         KEY ECONOMIC INDICATORS
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
GNP DEFLATOR      74 PDGNP     0.000    -1.822  -0.8    -0.971  -0.4    -0.853  -0.3    -1.248  -0.5    -2.810  -1.0
PRIV CONS DEFL     4 PDCE      0.000     0.822   0.3     0.850   0.3    -0.449  -0.2    -2.232  -0.8    -3.729  -1.3
EXP GOODS DEFL  1570 PDTEBGTE  0.000     5.289   1.9     7.237   2.5     3.610   1.2    -1.419  -0.4    -3.246  -1.0
IMP GOODS DEFL  1529 PDTMBGTE   0.00     37.57  13.1     26.95   8.8      5.40   1.6    -16.70  -4.8    -16.65  -4.5
WAGE RATE INDEX  378 WRCMF$   0.0000    0.0273   0.2    0.0493   0.3   -0.0173  -0.1   -0.1380  -0.8   -0.2025  -1.5
UNEMPLOYMENT(%)    9 NRUT     0.0000    0.2558   3.5    0.5384   7.6    0.5296   8.1    0.3052   4.7    0.0207   0.3
CAPACITY UTIL(%)  89 CUMIP    0.0000   -0.4461  -0.5   -0.8600  -1.0   -0.7585  -0.9   -0.2610  -0.3    0.2197   0.2
FED FUNDS RATE   433 FRMFF    0.0000   -0.4844  -6.4   -0.4048  -5.3   -0.5027  -5.2   -0.4334  -4.6   -0.5888  -6.6
PRIME RATE       671 FRMPRIME 0.0000   -0.3586  -3.7   -0.3400  -3.1   -0.3353  -2.8   -0.2972  -2.6   -0.4019  -3.5
TREAS BILL RATE  111 FRMTB3MY 0.0000   -0.3673  -4.5   -0.2987  -3.2   -0.3001  -3.1   -0.2653  -2.8   -0.3810  -4.1
UNBORROWED RES B 241 FRENS+   0.0000    0.0000   0.0    0.0000   0.0    0.0000   0.0    0.0000   0.0    0.0000   0.0
MONEY SUPPLY M1B 355 FM1B$     0.000    -0.259   0.0    -1.939  -0.3    -2.190  -0.3    -1.660  -0.2    -1.772  -0.2
FED GOV S/D      112 GVSURPF$  0.000    56.717 -28.4    43.616 -20.6    20.784  -9.6    -1.052   0.5     1.921  -0.9
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Table A.6

US

US TARIFF, $ DEPREC. 10% INT. RATE -2% PROJECT LINK FRI APR 5 17:34:18

AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)

			1985-1	1986-1	%CHG	1987-1	%CHG	1988-1	%CHG	1989-1	%CHG	1990-1	%CHG
PRIV CONSUMPTION	136	CE$	-0.001	15.121	0.6	30.893	1.1	40.602	1.3	47.228	1.4	50.300	1.7
PUBL CONSUMPTION	206	GVPT$	0.0000	0.0000	0.0	0.0000	0.0	0.0000	0.0	0.0000	0.0	0.0000	0.0
FEDERAL EXP	203	GVPF$	0.0000	0.0000	0.0	0.0000	0.0	0.0000	0.0	0.0000	0.0	0.0000	0.0
DEFENSE EXP	204	GVPFD$	0.0000	0.0000	0.0	0.0000	0.0	0.0000	0.0	0.0000	0.0	0.0000	0.0
PRIV INVESTMENT	194	IBT$	0.000	9.156	1.3	25.427	3.1	25.953	3.0	40.824	4.3	55.332	5.2
INVENTORY CHANGE	195	IBII$	0.00	-14.23	-49.6	-6.05	-28.7	0.46	2.7	7.75	24.3	6.14	15.3
EXPORT GOOD+SERV	1572	TEB$	0.000	11.911	2.9	15.066	3.3	16.010	3.1	19.621	3.4	24.585	3.9
IMPORT GOOD+SERV	1531	IMB$	0.000	84.185	15.9	69.328	12.0	51.944	8.1	37.802	5.3	50.312	6.3
GROSS NATL PROD	238	GNP$	0.00	-48.00	-1.2	2.06	0.0	30.62	0.6	60.00	1.3	80.00	1.6

AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, 1972 PRICES)

			1985-1	1986-1	%CHG	1987-1	%CHG	1988-1	%CHG	1989-1	%CHG	1990-1	%CHG
PRIV CONSUMPTION	49	CE	0.000	-1.139	-0.1	3.104	0.3	12.341	1.0	20.571	1.7	26.217	2.1
- DURABLES	58	CED	0.000	1.155	0.6	4.942	2.4	9.238	4.4	12.005	5.5	14.002	6.2
- NON-DURABLES	123	CEN	0.000	-2.324	-0.6	-3.500	-0.8	-1.152	-0.3	2.431	0.5	5.227	1.1
- SERVICES	38	CES	0.0000	0.0305	0.0	1.6821	0.3	4.2551	0.8	6.1353	1.1	6.0000	1.2
PUBL CONSUMPTION	47	GVPT	0.0000	-0.6177	-0.2	-0.8733	-0.3	-0.2173	-0.1	0.2224	0.1	0.0710	0.0
FEDERAL EXP	211	GVPF	-0.0001	-0.2950	-0.2	-0.4276	-0.3	-0.1002	-0.1	0.1336	0.1	0.1022	0.1
DEFENSE EXP	200	GVPFD	0.0000	-0.2481	-0.2	-0.3661	-0.3	-0.0867	-0.1	0.1100	0.1	0.0016	0.1
NON-RES INVEST	48	IBFN	0.000	0.762	0.3	2.113	0.8	4.576	1.7	10.795	3.8	16.050	5.3
RESIDENTIAL INVT	28	IBFR	0.0000	6.5002	10.3	9.3220	14.3	5.1326	7.8	2.1406	3.2	0.8273	1.2
INVENTORY CHANGE	39	IBII	0.000	-6.747	-50.1	-3.656	-33.1	-0.470	-5.6	2.930	21.7	2.271	13.7
EXPORT GOOD+SERV	1573	TEB	-0.0001	1.5270	1.0	0.6585	0.4	1.9565	1.1	4.5871	2.4	6.3507	3.1
IMPORT GOOD+SERV	1532	IMB	0.000	-8.696	-4.5	-9.630	-4.8	-5.220	-2.5	1.064	0.5	4.127	1.7
GROSS NATL PROD	36	GNP	0.000	9.070	0.5	20.297	1.1	28.530	1.5	40.182	2.1	47.670	2.4

BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)

			1985-1	1986-1	%CHG	1987-1	%CHG	1988-1	%CHG	1989-1	%CHG	1990-1	%CHG
EXPORTS SITC 0-1	601	VXL01	0.0050	1.4197	3.7	1.5607	3.6	1.5346	3.1	1.7438	3.1	1.9701	3.1
SITC 2+4	602	VXL24	0.0000	1.9059	6.5	2.7997	9.3	2.8744	8.9	2.7991	8.2	3.0349	8.3
SITC 3	603	VXL3	0.0000	0.3655	2.6	0.3815	2.8	0.4379	2.9	0.4977	3.1	0.5712	3.3
SITC 5-9	604	VXL59	0.000	10.771	6.4	13.809	7.3	14.476	6.9	16.753	7.0	19.036	7.1
ALL GOODS	605	VXL09	0.000	14.462	5.8	18.551	6.7	19.323	6.3	21.793	6.3	24.612	6.4
IMPORTS SITC 0-1	614	VML01	0.000	-3.038	-10.5	-2.804	-9.0	-1.420	-4.1	0.390	1.0	0.500	1.2
SITC 2+4	615	VML24	0.0000	0.2709	2.3	0.5621	4.2	0.7113	4.9	0.9712	6.0	1.0309	5.7
SITC 3	616	VML3	0.000	1.414	2.2	3.411	5.0	6.626	8.6	10.665	12.7	13.937	15.3
SITC 5-9	624	VML59	0.000	8.098	2.9	5.987	2.0	13.278	3.9	25.371	6.7	34.391	8.1
ALL GOODS	625	VML09	0.000	6.753	1.8	7.156	1.7	19.188	4.1	37.396	7.2	49.867	8.6
FOB TRADE BAL	644	TBL	0.00	7.71	-5.7	11.40	-8.0	0.14	-0.1	-15.60	9.0	-25.26	13.2
CURRENT ACCOUNT	1435	IBPCABOP	0.00	9.51	-7.0	12.12	-8.3	-0.54	0.3	-18.18	10.1	-25.73	13.1
AVG EXCH RATE	1446	REXAV750	0.0000	9.3809	11.1	9.8925	11.1	9.9396	11.1	9.9696	11.1	9.9657	11.1

KEY ECONOMIC INDICATORS

			1985-1	1986-1	%CHG	1987-1	%CHG	1988-1	%CHG	1989-1	%CHG	1990-1	%CHG
GNP DEFLATOR	74	PDGNP	0.000	-3.994	-1.7	-2.684	-1.1	-2.347	-0.9	-2.052	-0.8	-2.384	-0.8
PRIV CONS DEFL	4	PDCE	0.000	1.570	0.7	1.990	0.8	0.731	0.3	-0.632	-0.2	-1.107	-0.4
EXP GOODS DEFL	1570	PDTEBGTE	0.000	9.324	3.4	13.595	4.7	10.086	3.4	5.341	1.7	4.122	1.2
IMP GOODS DEFL	1529	PDTMBGTE	0.000	83.170	28.9	71.825	23.4	46.809	14.1	22.165	6.3	22.999	6.2
WAGE RATE INDEX	378	WRCMF$	0.0000	0.0609	0.4	0.1398	0.9	0.1198	0.7	0.0772	0.5	0.0984	0.6
UNEMPLOYMENT(%)	9	NRUT	0.000	-0.039	-0.5	-0.454	-6.4	-0.987	-15.0	-1.409	-21.7	-1.631	-26.0
CAPACITY UTIL(%)	89	CUWIP	0.0000	0.5626	0.7	1.5504	1.9	2.3330	2.8	2.9677	3.4	3.1762	3.6
FED FUNDS RATE	433	FRMFF	0.000	-3.027	-40.1	-2.030	-31.1	-2.016	-30.1	-2.557	-27.2	-2.731	-30.7
PRIME RATE	671	FRMPRIME	0.000	-1.020	-10.7	-2.125	-19.2	-2.150	-18.1	-1.904	-16.9	-2.015	-17.7
TREAS BILL RATE	111	FRMTB3MY	0.000	-1.875	-22.9	-1.871	-20.0	-1.929	-19.7	-1.728	-18.2	-1.817	-19.7
UNBORROWED RES B	241	FREN$+	0.0000	4.7000	10.3	4.4000	9.5	4.5000	9.2	4.0000	7.8	4.0000	7.4
MONEY SUPPLY M1B	355	FM1B$	0.000	24.824	4.0	26.544	4.1	28.028	4.1	27.398	3.7	27.835	3.6
FED GOV S/D	112	GVSURPF$	0.000	70.729	-35.4	81.757	-38.5	72.393	-33.5	62.453	-28.9	77.730	-37.9

Table A.7

```
                                                      US
US TARIFF, $ DEPREC  10% INT  RATE +2%                                              PROJECT LINK  FRI APR   5  17:17:28
-----------------------------------------------------------------------------------------------------------------------
                                AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1939-1 %CHG   1990-1 %CHG
PRIV CONSUMPTION 136 CE$          0.00     9.07   0.3     4.62   0.2   -15.59  -0.5   -34.20  -1.0   -48.38  -1.4
PUBL CONSUMPTION 206 GVPT$      0.0000   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
FEDERAL EXP      203 GVPF$      0.0000   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
DEFENSE EXP      204 GVPFD$     0.0000   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INVESTMENT  194 IBI$         0.00    -6.21  -0.8   -33.38  -4.1   -53.35  -6.1   -47.02  -4.9   -48.92  -4.6
INVENTORY CHANGE 195 IBIT$        0.00   -15.96 -55.6   -12.56 -52.7    -5.01 -29.7     5.10  16.0     5.63  14.1
EXPORT GOOD+SERV1572 TEB$        0.000   10.479   2.5   10.677   2.3    6.301   1.3    3.771   0.7    2.087   0.4
IMPORT GOOD+SERV1531 TMB$         0.00    76.09  14.3    39.68   6.9     1.13   0.2   -20.24  -3.7   -23.96  -3.0
GROSS NATL PROD  238 GNP$         0.00   -62.75  -1.5   -57.75  -1.3   -63.68  -1.3   -51.20  -1.0   -70.56  -1.2
-----------------------------------------------------------------------------------------------------------------------
                                 AGGREGATE DEMAND (BILLIONS OF U.S. DOLLARS, 1972 PRICES)
                                1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
PRIV CONSUMPTION  49 CE           0.00    -9.04  -0.8   -25.98  -2.2   -38.63  -3.2   -43.75  -3.6   -40.56  -3.2
  - DURABLES      58 CED          0.00    -3.06  -1.6    -9.06  -4.5   -13.96  -6.7   -15.08  -7.3   -15.08  -6.7
  - NON-DURABLES 123 CEN          0.00    -3.25  -0.8    -9.93  -2.3   -14.43  -3.3   -16.11  -3.6   -14.40  -3.1
  - SERVICES      38 CES          0.00    -2.73  -0.5    -6.98  -1.3   -10.24  -1.9   -11.76  -2.1   -11.97  -1.9
PUBL CONSUMPTION  47 GVPT        0.000   -1.313  -0.4   -3.521  -1.1   -4.402  -1.3   -4.244  -1.2   -2.641  -0.7
FEDERAL EXP      211 GVPF        0.000   -0.624  -0.5   -1.676  -1.2   -1.969  -1.4   -1.888  -1.2   -1.076  -0.7
DEFENSE EXP      208 GVPFD       0.000   -0.525  -0.5   -1.437  -1.4   -1.716  -1.6   -1.603  -1.4   -0.967  -0.8
NON-RES INVEST    48 IBFN         0.00    -2.57  -1.1   -12.63  -4.9   -21.61  -8.0   -23.75  -8.3   -23.31  -7.6
RESIDENTIAL INVT  28 IBFR        0.000    1.623   2.5   -6.092  -9.3   -9.637 -14.7   -7.731 -11.5   -4.673  -6.7
INVENTORY CHANGE  39 IBIT        0.000   -7.475 -55.5   -6.044 -54.8   -2.618 -31.2    2.110  15.6    2.492  15.1
EXPORT GOOD+SERV1573 TEB         0.000    0.595   0.4   -2.188  -1.3   -3.015  -1.7   -1.907  -1.0   -0.409  -0.2
IMPORT GOOD+SERV1532 TMB          0.00   -10.85  -5.6   -17.32  -8.7   -17.90  -8.5   -14.29  -6.4   -11.53  -4.8
GROSS NATL PROD   36 GNP          0.00    -7.34  -0.4   -39.13  -2.2   -61.93  -3.3   -64.97  -3.4   -57.57  -2.9
-----------------------------------------------------------------------------------------------------------------------
                            BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
EXPORTS SITC 0-1 601 VXL01      0.0000   1.2876   3.4   1.2650   2.9   0.9466   1.9   0.8002   1.4   0.6556   1.0
        SITC 2+4 602 VXL24      0.0000   1.8241   6.2   2.4707   8.2   2.1552   6.7   1.6318   4.8   1.6011   4.4
        SITC 3   603 VXL3       0.0000   0.3392   2.5   0.3134   2.3   0.3107   2.1   0.3058   1.9   0.3132   1.8
        SITC 5-9 604 VXL59       0.000   10.031   5.9   11.680   6.2   10.073   4.8    9.739   4.1    9.534   3.6
       ALL GOODS 605 VXL09       0.000   13.482   5.4   15.729   5.7   13.485   4.4   12.477   3.6   12.104   3.1
IMPORTS SITC 0-1 614 VML01       0.000   -2.973 -10.3   -2.677  -8.6   -1.348  -3.8    0.275   0.7    0.266   0.6
        SITC 2+4 615 VML24      0.0000   0.1185   1.0   0.0031   0.0  -0.1363  -0.9  -0.0870  -0.5  -0.1583  -0.9
        SITC 3   616 VML3        0.000    0.185   0.3   -2.556  -3.7   -5.630  -7.3   -7.033  -9.4   -9.298 -10.2
        SITC 5-9 624 VML59        0.00     3.03   1.1   -10.99  -3.6   -17.38  -5.1   -15.22  -4.0   -12.76  -3.0
       ALL GOODS 625 VML09        0.00     0.36   0.1   -16.21  -3.9   -24.49  -5.3   -22.96  -4.4   -21.95  -3.8
FOB TRADE BAL    644 TBL         0.000   13.118  -9.7   31.944 -22.5   37.980 -23.9   35.440 -20.4   34.058 -17.8
CURRENT ACCOUNT 1435 TBPCABOP    0.000   14.838 -10.9   33.730 -23.2   37.471 -23.1   30.013 -16.6   26.648 -13.5
AVG EXCH RATE   1445 REXAV75W   0.0000   9.3809  11.1   9.8925  11.1   9.9306  11.1   9.9696  11.1   9.9657  11.1
-----------------------------------------------------------------------------------------------------------------------
                                              KEY ECONOMIC INDICATORS
                                1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
GNP DEFLATOR      74 PDGNP       0.000   -2.595  -1.1    2.296   0.9    5.504   2.1    6.848   2.5    4.930   1.7
PRIV CONS DEFL     4 PDCE      -0.0001   2.7154   1.2   6.0280   2.5   7.2163   2.8   6.9895   2.6   5.3499   1.9
EXP GOODS DEFL  1570 PDTEBGTE    0.000    9.391   3.4   13.519   4.7    8.776   2.9    1.089   0.6   -2.293  -0.7
IMP GOODS DEFL  1529 PDTMBGTE    0.000   82.656  28.7   68.939  22.4   40.451  12.3   12.644   3.6   10.324   2.8
WAGE RATE INDEX  378 WRCMF$     0.0000   0.0925   0.6   0.3056   2.0 [illegible]  2.5   0.3936   2.3   0.2663   1.5
UNEMPLOYMENT(%)    9 NRUT       0.0000   0.2042   2.8   0.8779  12.4 [illegible] 24.3   1.9357  29.9   1.7700  28.3
CAPACITY UTIL(%)  89 CUMIP       0.000    0.009   0.0   -1.276  -1.5 [illegible] [illegible] -2.327 -2.7 -1.376 -1.5
FED FUNDS RATE   433 FRMFF      0.0000   2.2338  29.6   2.5794  28.4 [illegible] [illegible] 2.7580 29.4 2.8200 31.8
PRIME RATE       671 FRMPRIME   0.0000   1.1755  12.1   1.9553  17.6 [illegible] [illegible] 2.1126 18.2 2.0765 18.2
TREAS BILL RATE  111 FRMTB3MY   0.0000   1.2406  15.1   1.8010  19.2   1.9353 [illegible] 1.9386 20.4  1.9177  20.8
UNBORROWED RES B 241 FREN$+      0.000   -4.700 -10.3   -4.400  -9.5   -4.500  -9.2   -4.000  -7.8   -4.000  -7.4
MONEY SUPPLY M1B 355 FM1B$        0.00   -24.33  -4.0   -29.48  -4.5   -31.13  -4.5   -28.91  -3.9   -29.07  -3.7
FED GOV S/D      112 GVSURPF$     0.00    55.50 -27.8    24.69 -11.6   -20.75   9.6   -59.69  27.6   -71.73  34.9
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Table A.8

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US TARIFF, 86: 20%, 87: 15%, 88: 7%                    JAPAN                              PROJECT LINK  FRI APR   5  14:36:19
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                                       AGGREGATE DEMAND (BILLIONS OF YEN, CURRENT PRICES)
                              1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
PRIV CONSUMPTION   24 CV          0.      -88.   0.0    -324  -0.2     -780.  -0.4   -1247.  -0.5   -1454.  -0.6
PUBL CONSUMPTION  155 CGV        0.0     -25.4  -0.1   -77.3  -0.2    -165.0  -0.4   -241.5  -0.6   -247.6  -0.5
PRIV INVESTMENT    26 IFV        0.0     -90.5  -0.2  -238.0  -0.4    -339.6  -0.6   -300.7  -0.5   -154.0  -0.2
HOUSING INVEST     25 IHV        0.0     -17.4  -0.1   -55.0  -0.3    -106.1  -0.5   -140.2  -0.7   -140.5  -0.6
PUBL INVESTMENT   208 IGV        0.0     -16.6  -0.1   -44.1  -0.2     -89.0  -0.4   -123.2  -0.5   -119.0  -0.4
PRIV INV CHANGE    27 IIPV      0.00    -38.51  -1.6  -69.23  -3.1    -71.96  -2.9   -26.85  -1.2    20.39   0.9
GOV INV CHANGE    214 IIGV    0.0000    0.0000   0.0  0.0000   0.0    0.0000   0.0   0.0000   0.0   0.0000   0.0
EXPORTS OF G&S     28 EGSV       0.0    -658.4  -1.1  -988.5  -1.7    -995.2  -1.6   -669.7  -1.0   -399.5  -0.6
IMPORTS OF G&S     31 MGSV       0.0      14.0   0.0   -73.6  -0.2    -213.6  -0.5   -305.0  -0.6   -299.7  -0.5
GROSS DOM PROD     34 GDPV        0.     -876.  -0.3   -1630  -0.5    -2271.  -0.6   -2441.  -0.6   -2227.  -0.5
-----------------------------------------------------------------------------------------------------------------------------
                                       AGGREGATE DEMAND (BILLIONS OF YEN, 1975 PRICES)
                              1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
PRIV CONSUMPTION    3 C          0.0     -28.0   0.0  -116.4  -0.1    -227.9  -0.2   -304.0  -0.2   -326.6  -0.2
PUBL CONSUMPTION    5 CG      0.0000    0.0000   0.0  0.0000   0.0    0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INVESTMENT     7 IF         0.0     -76.9  -0.2  -204.8  -0.4    -256.1  -0.5   -176.7  -0.3    -34.9  -0.1
HOUSING INVEST      6 IH        0.00     -4.30   0.0  -13.25  -0.1    -18.00  -0.2   -19.35  -0.2   -21.54  -0.2
PUBL INVESTMENT    12 IG      0.0000    0.0000   0.0  0.0000   0.0    0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INV CHANGE    13 IIP       0.00    -28.75  -1.6  -51.41  -3.1    -51.51  -2.9   -17.47  -1.1    16.20   1.0
GOV INV CHANGE    212 IIG     0.0000    0.0000   0.0  0.0000   0.0    0.0000   0.0   0.0000   0.0   0.0000   0.0
EXPORTS OF G&S     14 EGS        0.0    -535.5  -1.0  -798.7  -1.5    -677.7  -1.2   -271.1  -0.5     11.7   0.0
IMPORTS OF G&S     17 MGS        0.0     -90.6  -0.3  -181.9  -0.6    -241.0  -0.7   -226.9  -0.6   -177.0  -0.5
GROSS DOM  PROD    20 GDP        0.0    -582.9  -0.2  -992.7  -0.4    -909.6  -0.4   -561.7  -0.2   -178.2  -0.1
-----------------------------------------------------------------------------------------------------------------------------
                          BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                              1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
EXPORTS SITC 0-1 329 VXL01    0.0000   -0.0467  -2.9 -0.0484  -2.8   -0.0357  -1.9  -0.0158  -0.8  -0.0154  -0.7
        SITC 2+4 330 VXL24    0.0000    0.0177   1.2  0.0274   1.7    0.0023   0.1  -0.0341  -1.0  -0.0470  -2.3
        SITC 3   331 VXL3     0.0000   -0.0021  -0.3 -0.0038  -0.6   -0.0047  -0.7  -0.0041  -0.6  -0.0029  -0.4
        SITC 5-9 332 VXL59     0.000    -2.834  -1.3  -4.542  -2.0    -4.456  -1.8   -2.767  -1.1   -1.412  -0.5
       ALL GOODS 333 VXL09     0.000    -2.865  -1.3  -4.567  -2.0    -4.494  -1.8   -2.821  -1.1   -1.477  -0.5
IMPORTS SITC 0-1 339 VML01    0.0000   -0.0270  -0.1 -0.0699  -0.4   -0.1435  -0.8  -0.2268  -0.9  -0.2810  -1.0
        SITC 2+4 340 VML24    0.0000    0.1640   0.6  0.2619   1.0    0.1451   0.5  -0.0383  -0.1  -0.0991  -0.3
        SITC 3   341 VML3     0.0000   -0.0968  -0.2 -0.2327  -0.4   -0.3884  -0.7  -0.4041  -0.7  -0.4422  -0.8
        SITC 5-9 342 VML59    0.0000    0.0415   0.1 -0.1534  -0.3   -0.3295  -0.7  -0.3468  -0.6  -0.2266  -0.4
       ALL GOODS 343 VML09     0.000     0.082   0.1  -0.194  -0.1    -0.716  -0.5   -1.076  -0.6   -1.049  -0.5
FOR TRADE BAL    362 TBL       0.000    -2.947  -3.0  -4.373  -5.3    -3.778  -4.4   -1.745  -2.1   -0.428  -0.5
EXCH RATE(LOC/$) 267 YENDOL   0.0000    0.0000   0.0  0.0000   0.0    0.0006   0.0   0.0000   0.0   0.0000   0.0
-----------------------------------------------------------------------------------------------------------------------------
                                              KEY ECONOMIC INDICATORS
                              1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
GNP DEFLATOR       95 P       0.0000   -0.0003   0.0 -0.0009  -0.1   -0.0033  -0.2  -0.0060  -0.4  -0.0069  -0.5
PRIV CONS DEFL    391 PC      0.0000   -0.0004   0.0 -0.0011  -0.1   -0.0031  -0.2  -0.0054  -0.3  -0.0063  -0.4
PRIV INV DEFL      90 PIF     0.0000   -0.0007   0.0 -0.0001   0.0   -0.0009  -0.1  -0.0018  -0.2  -0.0020  -0.2
EXP UV INDEX US$   84 PEC     0.0000   -0.0008   0.0 -0.0034  -0.2   -0.0075  -0.4  -0.0106  -0.5  -0.0113  -0.5
IMP UV INDEX US$  161 PMC     0.0000    0.0668   0.4  1.1004   0.5    0.0055   0.3  -0.0505   0.0  -0.3322  -0.1
NOM WAGE PER CA    73 W       0.0000   -0.0520  -0.1 -0.1481  -0.3   -0.2022  -0.6  -0.3678  -0.8  -0.3357  -0.7
UNEMPLOYMENT %    103 RU      0.0000    0.0140   0.6  0.0225   1.2    0.0235   1.2   0.0054   0.3  -0.0166  -1.0
INTEREST RATE %   137 RLB     0.0000   -0.0012   0.0 -0.0023   0.0   -0.0061  -0.1  -0.0066  -0.1  -0.0021   0.0
IND PROD INDEX    104 O        0.000    -0.647  -0.4  -1.169  -0.6    -1.240  -0.6   -0.813  -0.4   -0.356  -0.2
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NOTES: NOTE  CG PMSDOL AND IG ARE EXOGENOUS
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Table A.9

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US TARIFF WITH RETALIATION                    JAPAN                         PROJECT LINK  FRI APR   5  10:54:50
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                              AGGREGATE DEMAND (BILLIONS OF YEN, CURRENT PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG     1989-1 %CHG     1990-1 %CHG
PRIV CONSUMPTION   24 CV         0.0     546.1   0.3    605.4   0.3    202.2   0.1    -436.9  -0.2    -961.1  -0.4
PUBL CONSUMPTION  155 CGV        0.0     149.2   0.4    109.3   0.5    126.1   0.3     -51.0  -0.1    -184.5  -0.4
PRIV INVESTMENT    26 IFV        0.0 [illegible]   1.1    390.4   0.7     -2.2   0.0    -314.6  -0.5    -220.6  -0.3
HOUSING INVEST     25 IHV        0.0      47.5   0.3     27.5   0.1     -7.3   0.0     -71.7  -0.3    -103.9  -0.5
PUBL INVESTMENT   208 IGV        0.0     133.0   0.6    163.4   0.7     97.2   0.4     -32.3  -0.1    -100.5  -0.4
PRIV INV CHANGE    27 IIPV       0.0      99.3   4.2    -75.1  -3.3   -107.5  -4.4     -81.0  -3.5      24.2   1.0
GOV INV CHANGE    214 IIGV    0.0000    0.0000   0.0   0.0000   0.0   0.0000   0.0    0.0000   0.0    0.0000   0.0
EXPORTS OF G&S     28 EGSV       0.0     190.2   0.3   -267.5  -0.4   -474.1  -0.7    -473.1  -0.7    -207.7  -0.3
IMPORTS OF G&S     31 MGSV       0.0    1263.7   3.0    652.8   1.6    132.0   0.3    -389.6  -0.8    -312.8  -0.6
GROSS DOM PROD     34 GDPV        0.       684   0.2     609.   0.2     -53.   0.0    -1039.  -0.3    -1454.  -0.3
-----------------------------------------------------------------------------------------------------------------
                              AGGREGATE DEMAND (BILLIONS OF YEN, 1975 PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG     1989-1 %CHG     1990-1 %CHG
PRIV CONSUMPTION    3 C          0.0     -98.7  -0.1   -200.7  -0.2   -251.1  -0.2    -247.1  -0.2    -215.3  -0.2
PUBL CONSUMPTION    5 CG      0.0000    0.0000   0.0   0.0000   0.0   0.0000   0.0    0.0000   0.0    0.0000   0.0
PRIV INVESTMENT     7 IF         0.0     171.0   0.4     14.7   0.0   -210.2  -0.4    -269.0  -0.5    -100.5  -0.2
HOUSING INVEST      6 IH        0.00    -41.79  -0.4   -50.69  -0.5   -39.67  -0.3    -29.28  -0.2    -14.96  -0.1
PUBL INVESTMENT    12 IG      0.0000    0.0000   0.0   0.0000   0.0   0.0000   0.0    0.0000   0.0    0.0000   0.0
PRIV INV CHANGE    13 IIP       0.00     62.37   3.6   -65.97  -4.0   -64.26  -4.0    -57.69  -3.5     10.59   1.2
GOV INV CHANGE    212 IIG     0.0003    0.0000   0.0   0.0000   0.0   0.0000   0.0    0.0000   0.0    0.0000   0.0
EXPORTS OF G&S     14 EGS        0.0    -119.8  -0.2   -543.0  -1.0   -545.3  -0.9    -264.2  -0.4      97.5   0.2
IMPORTS OF G&S     17 MGS        0.0    -423.9  -1.4   -388.9  -1.0   -381.4  -1.5    -289.6  -0.8    -153.3  -0.4
GROSS DOM  PROD    20 GDP        0.0     396.9   0.2   -256.7  -0.1   -629.1  -0.2    -589.0  -0.2     -69.3   0.0
-----------------------------------------------------------------------------------------------------------------
                         BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG     1989-1 %CHG     1990-1 %CHG
EXPORTS SITC 0-1 329 VXL01    0.0000    0.0232   1.4   0.0058   0.3  -0.0094  -0.5   -0.0229  -1.1   -0.0195  -0.9
        SITC 2+4 330 VXL24    0.0000    0.1309   9.6   0.1100   7.0   0.0320   1.9   -0.0715  -3.0   -0.0565  -2.7
        SITC 3   331 VXL3     0.0000    0.0216   3.6   0.0138   2.1   0.0032   0.5   -0.0087  -1.2   -0.0104  -1.3
        SITC 5-9 332 VXL59     0.000     0.693   0.3   -1.326  -0.6   -2.161  -0.9    -1.990  -0.8    -0.702  -0.3
       ALL GOODS 333 VXL09     0.000     0.877   0.4   -1.196  -0.5   -2.138  -0.9    -2.093  -0.8    -0.789  -0.3
IMPORTS SITC 0-1 339 VML01    0.0000    0.0878   0.5   0.0665   0.0  -0.1496  -0.7   -0.2873  -1.1   -0.3697  -1.3
        SITC 2+4 340 VML24    0.0000    0.3832   1.5   0.6127   2.2   0.5490   1.9    0.2131   0.7    0.0932   0.3
        SITC 3   341 VML3     0.0000    0.9335   1.0   0.4446   0.0  -0.0144   0.0   -0.5295  -0.8   -0.5723  -0.8
        SITC 5-9 342 VML59     0.000    -1.160  -2.8   -1.094  -4.3   -1.909  -3.3    -0.007  -1.5    -0.284  -0.4
       ALL GOODS 343 VML09     0.000     0.244   0.2   -0.830  -0.6   -1.223  -0.8    -1.410  -0.8    -1.113  -0.6
FOB TRADE BAL    362 TBL      0.0000    0.6324   0.8  -0.3660  -0.4  -0.9124  -1.1   -0.6826  -0.8    0.3239   0.4
EXCH RATE(LOC/$) 267 YENDOL   0.0000    0.0000   0.0   0.0000   0.0   0.0000   0.0    0.0000   0.0    0.0000   0.0
-----------------------------------------------------------------------------------------------------------------
                                        KEY ECONOMIC INDICATORS
                              1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG     1989-1 %CHG     1990-1 %CHG
GNP DEFLATOR       95 P       0.0000    0.0005   0.0   0.0039   0.3   0.0033   0.2   -0.0008  -0.1   -0.0048  -0.3
PRIV CONS DEFL    301 PC      0.0000    0.0057   0.4   0.0073   0.5   0.0053   0.3   -0.0002   0.0   -0.0042  -0.2
PRIV INV DEFL      90 PIF     0.0000    0.0078   0.7   0.0079   0.7   0.0048   0.4   -0.0001   0.0   -0.0017  -0.1
EXP UV INDEX US$   84 PEC     0.0000    0.0128   0.7   0.0110   0.6   0.0033   0.2   -0.0066  -0.3   -0.0090  -0.4
IMP UV INDEX US$  161 PMC      0.000    12.020   5.6    9.491   4.5    5.099   2.3    -0.062   0.0    -0.591  -0.2
NOM WAGE PER CA    73 W       0.0000    0.1119   0.3   0.1844   0.4   0.1057   0.2   -0.1219  -0.3   -0.2873  -0.6
UNEMPLOYMENT %    103 RU      0.0000   -0.0105  -0.5  -0.0001   0.0   0.0184   1.0    0.0319   1.8    0.0118   0.7
INTEREST RATE %   137 RLB     0.0000    0.0194   0.3   0.0057   0.1  -0.0062  -0.1   -0.0179  -0.3   -0.0127  -0.2
IND PROD INDEX    104 O        0.000     0.140   0.1   -0.872  -0.5   -1.218  -0.6    -0.974  -0.5    -0.235  -0.1
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NOTES  NOTE  CG PMSDOL AND IG ARE EXOGENOUS
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Table A.10

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US TARIFF EXCL. CANADA AND LDC                          JAPAN                          PROJECT LINK  TUE APR   9  17:49:49
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                                     AGGREGATE DEMAND (BILLIONS OF YEN, CURRENT PRICES)
                          1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
PRIV CONSUMPTION  24 CV       0.     -320.  -0.2    -814.  -0.4   -1456.  -0.7   -1786.  -0.8   -1640.  -0.7
PUBL CONSUMPTION 155 CGV     0.0     -89.6  -0.3   -194.7  -0.5   -307.5  -0.8   -331.1  -0.8   -237.7  -0.5
PRIV INVESTMENT   26 IFV     0.0    -323.9  -0.6   -539.5  -1.0   -432.1  -0.7   -188.2  -0.3     -5.7   0.0
HOUSING INVEST    25 IHV     0.0     -54.0  -0.3   -112.2  -0.6   -169.3  -0.9   -177.3  -0.9   -144.0  -0.6
PUBL INVESTMENT  208 IGV     0.0     -65.6  -0.3   -122.7  -0.5   -166.5  -0.7   -155.9  -0.6   -100.6  -0.4
PRIV INV CHANGE   27 IIPV    0.0    -111.6  -4.7    -96.3  -4.3    -42.7  -1.8     25.7   1.1     43.1   1.9
GOV INV CHANGE   214 IIGV 0.0000    0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
EXPORTS OF G&S    28 EGSV     0.    -1627.  -2.6   -1413.  -2.4   -1001.  -1.6    -422.  -0.6    -292.  -0.4
IMPORTS OF G&S    31 MGSV    0.0    -117.5  -0.3   -242.5  -0.6   -326.5  -0.8   -332.5  -0.7   -294.9  -0.5
GROSS DOM PROD    34 GDPV      0    -2326.  -0.7   -2953.  -0.8   -3219.  -0.9   -2740.  -0.7   -2128.  -0.5
----------------------------------------------------------------------------------------------------------------------------
                                     AGGREGATE DEMAND (BILLIONS OF YEN, 1975 PRICES)
                          1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
PRIV CONSUMPTION   3 C       0.0     -48.9   0.0   -195.6  -0.2   -342.4  -0.3   -400.9  -0.3   -406.3  -0.3
PUBL CONSUMPTION   5 CG   0.0000    0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INVESTMENT    7 IF      0.0    -217.7  -0.5   -381.0  -0.8   -260.7  -0.5    -53.3  -0.1     79.7   0.1
HOUSING INVEST     6 IH     0.00      4.37   0.0    -4.64   0.0   -15.82  -0.1   -25.81  -0.2   -32.23  -0.3
PUBL INVESTMENT   12 IG   0.0000    0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INV CHANGE   13 IIP    0.00    -81.23  -4.7   -68.85  -4.2   -28.36  -1.6    20.38   1.2    31.76   2.0
GOV INV CHANGE   212 IIG  0.0000    0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
EXPORTS OF G&S    14 EGS      0.    -1241.  -2.3    -992.  -1.8    -511.  -0.9      35.   0.1     123.   0.2
IMPORTS OF G&S    17 MGS     0.0    -116.4  -0.4   -227.9  -0.7   -276.2  -0.8   -255.4  -0.7   -204.6  -0.5
GROSS DOM  PROD   20 GDP      0.    -1468.  -0.6   -1414.  -0.6    -882.  -0.3    -178.  -0.1       1.   0.0
----------------------------------------------------------------------------------------------------------------------------
                            BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                          1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
EXPORTS SITC 0-1 329 VXL01 0.0000  -0.0338  -2.1  -0.0281  -1.6  -0.0175  -0.9  -0.0026  -0.1  -0.0035  -0.2
        SITC 2+4 330 VXL24 0.0000   0.0000   0.6   0.0137   0.9   0.0074   0.4  -0.0035  -0.2  -0.0138  -0.7
        SITC 3   331 VXL3  0.0000  -0.0012  -0.2  -0.0017  -0.3  -0.0021  -0.3  -0.0018  -0.2  -0.0015  -0.2
        SITC 5-9 332 VXL59  0.000   -7.091  -3.3   -6.458  -2.9   -4.340  -1.8   -1.463  -0.6   -0.859  -0.3
       ALL GOODS 333 VXL09  0.000   -7.118  -3.3   -6.474  -2.8   -4.352  -1.8   -1.471  -0.6   -0.878  -0.3
IMPORTS SITC 0-1 339 VML01 0.0000  -0.0260  -0.1  -0.1278  -0.6  -0.2597  -1.2  -0.3440  -1.3  -0.3338  -1.1
        SITC 2+4 340 VML24 0.0000  -0.0596  -0.2  -0.1397  -0.5  -0.1470  -0.5  -0.1027  -0.3  -0.0588  -0.2
        SITC 3   341 VML3  0.0000  -0.1229  -0.2  -0.3335  -0.6  -0.4753  -0.8  -0.5021  -0.8  -0.4367  -0.6
        SITC 5-9 342 VML59 0.0000  -0.1767  -0.4  -0.2599  -0.6  -0.2851  -0.6  -0.2312  -0.4  -0.1778  -0.3
       ALL GOODS 343 VML09  0.000   -0.385  -0.3   -0.861  -0.6   -1.167  -0.7   -1.180  -0.7   -1.007  -0.5
FOB TRADE BAL    362 TBL    0.000   -6.733  -8.7   -5.613  -6.8   -3.185  -3.7   -0.291  -0.4    0.129   0.2
EXCH RATE(LOC/$) 267 YENDOL 0.0000  0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
----------------------------------------------------------------------------------------------------------------------------
                                              KEY ECONOMIC INDICATORS
                          1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
GNP DEFLATOR       95 P   0.0000   -0.0012  -0.1  -0.0038  -0.3  -0.0075  -0.5  -0.0091  -0.6  -0.0075  -0.5
PRIV CONS DEFL    391 PC  0.0000   -0.0020  -0.1  -0.0040  -0.2  -0.0068  -0.4  -0.0081  -0.5  -0.0067  -0.4
PRIV INV DEFL      98 PIF 0.0000   -0.0017  -0.2  -0.0022  -0.2  -0.0026  -0.2  -0.0024  -0.2  -0.0017  -0.1
EXP UV INDEX US$   84 PEC 0.0000   -0.0056  -0.3  -0.0105  -0.5  -0.0127  -0.6  -0.0126  -0.6  -0.0120  -0.6
IMP UV INDEX US$  161 PMC 0.0000    0.2375   0.1   0.2609   0.1   0.1516   0.1   0.0006   0.0  -0.0097   0.0
NOM WAGE PER CA    73 W   0.0000   -0.1451  -0.3  -0.3239  -0.7  -0.4965  -1.1  -0.4799  -1.0  -0.2909  -0.6
UNEMPLOYMENT %    183 RU  0.0000    0.0353   1.6   0.0355   1.6   0.0236   1.2  -0.0199  -1.2  -0.0416  -2.5
INTEREST RATE %   137 RLB 0.0000   -0.0068  -0.1  -0.0063  -0.1  -0.0084  -0.1  -0.0027   0.0   0.0054   0.1
IND PROD INDEX    104 O    0.000    -1.560  -0.9   -1.638  -0.9   -1.162  -0.6   -0.426  -0.2   -0.185  -0.1
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NOTES: NOTE: CG PMSDOL AND IG ARE EXOGENOUS
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Table A.11

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US TARIFF AGAINST JAPAN ONLY                  JAPAN                      PROJECT LINK  FRI APR    5  18:09:54
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                                   AGGREGATE DEMAND (BILLIONS OF YEN, CURRENT PRICES)
                            1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION   24 CV        0.      -487   -0.1   -1186.  -0.6   -2033.  -0.9   -2368.  -1.0   -2043.  -0.8
PUBL CONSUMPTION  155 CGV      0.0    -136.0   -0.4   -284.8  -0.7   -430.4  -1.1   -436.0  -1.0   -283.4  -0.6
PRIV INVESTMENT    26 IFV      0.0    -489.7   -1.0   -774.2  -1.4   -560.1  -1.0   -181.9  -0.3     45.4   0.1
HOUSING INVEST     25 IHV      0.0     -80.2   -0.5   -159.1  -0.9   -230.1  -1.2   -227.5  -1.1   -172.1  -0.8
PUBL INVESTMENT   208 IGV      0.0    -100.6   -0.4   -181.7  -0.7   -233.5  -1.0   -202.5  -0.8   -117.2  -0.4
PRIV INV CHANGE    27 IIPV     0.0    -165.3   -7.0   -126.7  -5.6    -38.9  -1.6     55.9   2.4     63.4   2.7
GOV INV CHANGE    214 IIGV  0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
EXPORTS OF G&S     28 EGSV      0.     -2358.  -3.8   -1883.  -3.1   -1193.  -1.9    -337.  -0.5    -264.  -0.4
IMPORTS OF G&S     31 MGSV     0.0    -225.2   -0.5   -392.8  -1.0   -472.1  -1.1   -449.8  -0.9   -404.1  -0.7
GROSS DOM PROD     34 GDPV      0      -3385   -1.0   -4085.  -1.2   -4229.  -1.1   -3323.  -0.8   -2443.  -0.6
--------------------------------------------------------------------------------------------------------------
                                   AGGREGATE DEMAND (BILLIONS OF YEN, 1975 PRICES)
                            1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION    3 C        0.0     -66.4   -0.1   -265.9  -0.2   -455.6  -0.3   -526.0  -0.4   -502.9  -0.4
PUBL CONSUMPTION    5 CG    0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INVESTMENT     7 IF       0.0    -320.6   -0.7   -529.8  -1.1   -314.8  -0.6     -6.9   0.0    151.4   0.3
HOUSING INVEST      6 IH      0.00      8.32    0.1    -3.47   0.0   -19.64  -0.2   -34.23  -0.3   -42.38  -0.3
PUBL INVESTMENT    12 IG    0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INV CHANGE    13 IIP      0.0    -120.1   -6.9    -89.8  -5.5    -24.2  -1.4     42.8   2.6     46.6   2.9
GOV INV CHANGE    212 IIG   0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
EXPORTS OF G&S     14 EGS       0.     -1778.  -3.3   -1281.  -2.3    -538.  -0.9     224.   0.4     228.   0.4
IMPORTS OF G&S     17 MGS      0.0    -154.5   -0.5   -292.6  -0.9   -343.5  -1.0   -298.9  -0.8   -226.3  -0.6
GROSS DOM  PROD    20 GDP       0.     -2123.  -0.9   -1878.  -0.7   -1009.  -0.4      -1.   0.0     107.   0.0
--------------------------------------------------------------------------------------------------------------
                             BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                            1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
EXPORTS SITC 0-1 329 VXL01  0.0000   -0.0017   -0.1   0.0001   0.0   0.0016   0.1   0.0037   0.2   0.0087   0.4
        SITC 2+4 330 VXL24  0.0000    0.0065    0.4   0.0081   0.5   0.0050   0.3   0.0002   0.0  -0.0093  -0.4
        SITC 3   331 VXL3   0.0000    0.0020    0.3   0.0006   0.1  -0.0017  -0.2  -0.0055  -0.7  -0.0088  -1.1
        SITC 5-9 332 VXL59    0.00    -10.33   -4.8    -8.63  -3.8    -5.13  -2.1    -0.89  -0.3    -0.61  -0.2
       ALL GOODS 333 VXL09    0.00    -10.33   -4.7    -8.62  -3.8    -5.13  -2.1    -0.89  -0.3    -0.62  -0.2
IMPORTS SITC 0-1 339 VML01  0.0000   -0.1503   -0.8  -0.3199  -1.6  -0.4965  -2.2  -0.5951  -2.3  -0.5585  -1.9
        SITC 2+4 340 VML24  0.0000   -0.1481   -0.6  -0.2932  -1.1  -0.2626  -0.9  -0.1485  -0.5  -0.0668  -0.2
        SITC 3   341 VML3   0.0000   -0.1794   -0.3  -0.4749  -0.9  -0.6354  -1.1  -0.6621  -1.0  -0.6239  -0.9
        SITC 5-9 342 VML59  0.0000   -0.2890   -0.7  -0.3589  -0.8  -0.3448  -0.7  -0.2487  -0.4  -0.2063  -0.3
       ALL GOODS 343 VML09   0.000    -0.767   -0.5   -1.447  -1.0   -1.739  -1.1   -1.652  -0.9   -1.456  -0.7
FOB TRADE BAL    362 TBL     0.000    -9.560  -12.3   -7.178  -8.7   -3.388  -3.9    0.763   0.9    0.837   1.0
EXCH RATE(LOC/$) 267 YENDOL 0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
--------------------------------------------------------------------------------------------------------------
                                               KEY ECONOMIC INDICATORS
                            1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
GNP DEFLATOR       95 P     0.0000   -0.0018   -0.1  -0.0058  -0.4  -0.0107  -0.7  -0.0122  -0.8  -0.0092  -0.6
PRIV CONS DEFL    391 PC    0.0000   -0.0031   -0.2  -0.0060  -0.4  -0.0098  -0.6  -0.0109  -0.7  -0.0083  -0.5
PRIV INV DEFL      90 PIF   0.0000   -0.0029   -0.3  -0.0036  -0.3  -0.0039  -0.3  -0.0033  -0.3  -0.0023  -0.2
EXP UV INDEX US$   84 PEC   0.0000   -0.0092   -0.5  -0.0156  -0.8  -0.0174  -0.9  -0.0159  -0.8  -0.0145  -0.7
IMP UV INDEX US$  161 PMC   0.0000   -0.1334   -0.1  -0.2179  -0.1  -0.2490  -0.1  -0.3655  -0.2  -0.5466  -0.2
NOM WAGE PER CA    73 W     0.0000   -0.2145   -0.5  -0.4649  -1.0  -0.6867  -1.5  -0.6203  -1.3  -0.3264  -0.6
UNEMPLOYMENT %    103 RU    0.0000    0.0513    2.4   0.0483   2.5   0.0280   1.4  -0.0358  -2.1  -0.0612  -3.6
INTEREST RATE %   137 RLR   0.0000   -0.0107   -0.2  -0.0093  -0.2  -0.0110  -0.2  -0.0017   0.0   0.0092   0.2
IND PROD INDEX    184 O      0.000    -2.255   -1.3   -2.169  -1.2   -1.352  -0.7   -0.284  -0.1   -0.089   0.0
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NOTES  NOTE  CG PWSDOL AND IG ARE EXOGENOUS
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Table A.12

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US TARIFF AND 10% DOLLAR APPRECIATION              JAPAN                     PROJECT LINK  TUE APR   9  14:57:37
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                                    AGGREGATE DEMAND (BILLIONS OF YEN, CURRENT PRICES)
                            1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
PRIV CONSUMPTION  24 CV        0.0    925.7  0.5   1770.2  0.9   2700.2  1.3   3555.4  1.6   4428.4  1.8
PUBL CONSUMPTION 155 CGV       0.0    248.5  0.7    491.6  1.3    729.5  1.8    987.6  2.1   1038.2  2.3
PRIV INVESTMENT   26 IFV       0.0    820.8  1.6   1117.5  2.1   1165.8  2.0   1351.1  2.2   1637.8  2.5
HOUSING INVEST    25 IHV      0.00   104.91  0.6   162.42  0.8   250.53  1.3   330.25  1.6   410.92  1.9
PUBL INVESTMENT  208 IGV      0.00   212.58  0.9   376.81  1.5   494.17  2.0   578.03  2.2   652.28  2.4
PRIV INV CHANGE   27 IIPV     0.00   171.43  7.3    47.17  2.1    48.05  2.0    93.70  4.0   149.82  6.5
GOV INV CHANGE   214 IIGV   0.0000   0.0000  0.0   0.0000  0.0   0.0000  0.0   0.0000  0.0   0.0000  0.0
EXPORTS OF G&S    28 EGSV      0.0   2082.4  3.3   1701.9  2.8   2188.3  3.5   3031.2  4.5   3887.7  5.4
IMPORTS OF G&S    31 MGSV      0.0   2205.3  5.3   2047.2  5.1   2212.5  5.2   2613.2  5.4   3169.1  5.8
GROSS DOM PROD    34 GDPV      0.0   2224.5  0.7   3615.5  1.0   5360.7  1.4   7215.2  1.8   9048.5  2.1
------------------------------------------------------------------------------------------------------------------
                                    AGGREGATE DEMAND (BILLIONS OF YEN, 1975 PRICES)
                            1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
PRIV CONSUMPTION   3 C         0.0    -75.8 -0.1   -110.4 -0.1    -66.7 -0.1     35.3  0.0    205.3  0.1
PUBL CONSUMPTION   5 CG     0.0000   0.0000  0.0   0.0000  0.0   0.0000  0.0   0.0000  0.0   0.0000  0.0
PRIV INVESTMENT    7 IF       0.00   287.06  0.6   363.53  0.8   282.33  0.6   350.12  0.7   507.30  0.9
HOUSING INVEST     6 IH       0.00   -56.84 -0.5   -78.25 -0.7   -77.37 -0.7   -68.52 -0.6   -57.64 -0.5
PUBL INVESTMENT   12 IG     0.0000   0.0000  0.0   0.0000  0.0   0.0000  0.0   0.0000  0.0   0.0000  0.0
PRIV INV CHANGE   13 IIP      0.00   111.14  8.4    15.55  0.9    12.94  0.7    45.30  2.8    82.40  5.1
GOV INV CHANGE   212 IIG    0.0000   0.0000  0.0   0.0000  0.0   0.0000  0.0   0.0000  0.0   0.0000  0.0
EXPORTS OF G&S    14 EGS       0.0    518.4  1.0    482.0  0.9    712.6  1.2   1263.2  2.1   1716.1  2.7
IMPORTS OF G&S    17 MGS       0.0   -402.2 -1.3   -502.3 -1.6   -496.5 -1.5   -441.9 -1.2   -370.2 -1.0
GROSS DOM  PROD   20 GDP       0.0   1186.2  0.5   1174.6  0.5   1360.2  0.5   2087.2  0.8   2023.7  1.0
------------------------------------------------------------------------------------------------------------------
                              BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                              1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
EXPORTS SITC 0-1 329 VXL01    0.0000  -0.1213 -7.4  -0.1222 -7.0  -0.1041 -5.5  -0.0805 -3.9  -0.0730 -3.3
        SITC 2+4 330 VXL24    0.0000  -0.1077 -7.5  -0.1323 -8.4  -0.1717-10.0  -0.2267-12.1  -0.2940-14.2
        SITC 3   331 VXL3     0.0000  -0.0432 -7.1  -0.0477 -7.4  -0.0518 -7.4  -0.0539 -7.2  -0.0562 -6.9
        SITC 5-9 332 VXL59      0.00   -13.31 -6.2   -15.33 -6.8   -15.06 -6.3   -13.39 -5.2   -12.40 -4.5
       ALL GOODS 333 VXL09      0.00   -13.58 -6.2   -15.63 -6.8   -15.40 -6.3   -13.75 -5.3   -12.82 -4.5
IMPORTS SITC 0-1 339 VML01    0.0000  -0.3586 -1.9  -0.2488 -1.3  -0.0988 -0.4   0.0489  0.2   0.1575  0.5
        SITC 2+4 340 VML24     0.000   -0.881 -3.4   -1.000 -3.7   -1.140 -3.9   -1.298 -4.0   -1.308 -3.7
        SITC 3   341 VML3      0.000   -1.732 -3.2   -1.625 -2.9   -1.901 -3.2   -2.154 -3.3   -2.375 -3.3
        SITC 5-9 342 VML59     0.000   -2.275 -5.4   -2.911 -6.6   -3.201 -6.6   -3.349 -6.0   -3.386 -5.4
       ALL GOODS 343 VML09     0.000   -5.244 -3.7   -5.785 -3.9   -6.341 -4.0   -6.752 -3.8   -6.911 -3.5
FOB TRADE BAL    362 TBL       0.000   -8.337-10.8   -9.847-12.0   -9.064-10.5   -7.002 -8.5   -5.909 -7.2
EXCH RATE(LOC/$) 267 YENDOL    0.000   22.395 10.0   20.581 10.0   20.293 10.0   20.090 10.0   20.000 10.0
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                                          KEY ECONOMIC INDICATORS
                              1985-1   1986-1 %CHG   1987-1 %CHG   1988-1 %CHG   1989-1 %CHG   1990-1 %CHG
GNP DEFLATOR      95 P        0.0000   0.0023  0.2   0.0077  0.5   0.0139  0.9   0.0153  1.0   0.0169  1.1
PRIV CONS DEFL   391 PC       0.0000   0.0085  0.5   0.0153  1.0   0.0213  1.3   0.0255  1.5   0.0285  1.7
PRIV INV DEFL     90 PIF      0.0000   0.0110  1.0   0.0147  1.3   0.0167  1.4   0.0177  1.5   0.0185  1.6
EXP UV INDEX US$  84 PFC      0.0000  -0.1232 -6.4  -0.1368 -6.9  -0.1372 -6.8  -0.1374 -6.6  -0.1355 -6.3
IMP UV INDEX US$ 161 PMC       0.000   -8.035 -3.8   -7.784 -3.7   -8.225 -3.7   -8.713 -3.8   -8.901 -3.7
NOM WAGE PER CA   73 W        0.0000   0.2552  0.6   0.6237  1.4   0.9494  2.0   1.1421  2.3   1.2685  2.5
UNEMPLOYMENT %   103 RU       0.0000  -0.0433 -2.0  -0.0514 -2.7  -0.0416 -2.2  -0.0176 -1.0  -0.0142 -0.8
INTEREST RATE %  137 RLB      0.0000   0.1252  2.1   0.0434  0.7   0.0238  0.4   0.0150  0.3   0.0097  0.2
IND PROD INDEX   104 O        0.0000   0.9556  0.5   0.6729  0.4   0.8381  0.4   1.5906  0.8   2.4501  1.2
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NOTES  NOTE  CG PMSDOL AND IG ARE EXOGENOUS
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Table A.13

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US TARIFF, $ DEPREC  10% INT. RATE -2%               JAPAN                          PROJECT LINK  FRI APR   5  17:37:26
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                                    AGGREGATE DEMAND (BILLIONS OF YEN, CURRENT PRICES)
                                   1985-1    1986 1 %CHG    1987-1 %CHG.   1988-1 %CHG    1989-1 %CHG     1990-1 %CHG
PRIV CONSUMPTION   24 CV               0.    -1140   -0.6   -2376.  -1.2   -3958.  -1.8   -5261.  -2.3   -5872.  -2.4
PUBL CONSUMPTION  155 CGV              0      -310   -0.9    -640.  -1.7    -991.  -2.4   -1214.  -2.8   -1224.  -2.7
PRIV INVESTMENT    26 IFV              0     -1039   -2.0   -1578.  -2.9   -1660.  -2.9   -1587.  -2.6   -1450.  -2.2
HOUSING INVEST     25 IHV            0.0    -143.5   -0.8   -260.9  -1.4   -415.7  -2.1   -507.0  -2.4   -519.8  -2.3
PUBL INVESTMENT   208 IGV            0.0    -255.1   -1.1   -461.9  -1.9   -627.8  -2.6   -718.1  -2.8   -714.5  -2.6
PRIV INV CHANGE    27 IIPV           0.0    -255.2  -10.8   -161.6  -7.2   -133.6  -5.5    -65.2  -2.8    -19.5  -0.8
GOV INV CHANGE    214 IIGV        0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
EXPORTS OF G&S     28 EGSV             0.    -3223   -5.2   -3223.  -5.4   -3240.  -5.1   -2980.  -4.5   -2903.  -4.0
IMPORTS OF G&S     31 MGSV             0     -2247   -5.4   -2188.  -5.5   -2525.  -5.9   -2957.  -6.1   -3328.  -6.1
GROSS DOM PROD     34 GDPV             0     -3936   -1.2   -6365.  -1.8   -8439.  -2.2   -9428.  -2.4   -9525.  -2.3
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                                    AGGREGATE DEMAND (BILLIONS OF YEN, 1975 PRICES)
                                   1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG     1990-  %CHG
PRIV CONSUMPTION    3 C              0.0      26.4    0.0    -95.6  -0.1   -315.0  -0.2   -483.8  -0.4   -589.4  -0.4
PUBL CONSUMPTION    5 CG          0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INVESTMENT     7 IF             0.0    -462.4   -1.0   -768.5  -1.6   -680.0  -1.4   -485.8  -0.9   -305.7  -0.5
HOUSING INVEST      6 IH           0.000    52.434    0.5   57.438   0.5   47.281   0.4   37.453   0.3   26.629   0.2
PUBL INVESTMENT    12 IG          0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
PRIV INV CHANGE    13 IIP            0.0    -175.8  -10.1   -101.7  -6.2    -75.6  -4.3    -24.6  -1.5      8.5   0.5
GOV INV CHANGE    212 IIG         0.0000    0.0000    0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0   0.0000   0.0
EXPORTS OF G&S     14 EGS              0.    -1608.  -3.0    -1859.  -3.4   -1523.  -2.6   -1024.  -1.7    -782.  -1.2
IMPORTS OF G&S     17 MGS           0.00    319.08    1.0   255.09   0.8   212.56   0.6   280.39   0.8   406.81   1.1
GROSS DOM  PROD    20 GDP              0.    -2486.  -1.0   -3022.  -1.2   -2758.  -1.1   -2261.  -0.8   -2049.  -0.7
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                               BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                                   1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG     1990-1 %CHG
EXPORTS SITC 0-1 329 VXL01        0.0000    0.0400    2.5   0.0415   2.4   0.0562   2.9   0.0827   4.0   0.0881   3.9
        SITC 2+4 330 VXL24        0.0000    0.1570   10.9   0.2194  14.0   0.2284  13.3   0.2311  12.4   0.2774  13.4
        SITC 3   331 VXL3         0.0000    0.0452    7.5   0.0495   7.7   0.0549   7.8   0.0620   8.3   0.0707   8.7
        SITC 5-9 332 VXL59         0.000    10.447    4.9   11.003   4.9   13.357   5.5   17.298   6.7   20.907   7.6
       ALL GOODS 333 VXL09         0.000    10.690    4.9   11.314   4.9   13.696   5.6   17.674   6.8   21.343   7.8
IMPORTS SITC 0-1 339 VML01        0.0000    0.3268    1.8   0.1331   0.7  -0.1219  -0.5  -0.3521  -1.4  -0.4419  -1.5
        SITC 2+4 340 VML24        0.0000    1.3553    5.2   1.7562   6.4   1.7503   6.0   1.6495   5.1   1.6224   4.5
        SITC 3   341 VML3         0.0000    1.8124    3.4   1.4967   2.7   1.6368   2.8   2.0187   3.1   2.6378   3.7
        SITC 5-9 342 VML59        0.0000    2.7973    6.6   3.2505   7.3   3.3303   6.8   3.6099   6.5   4.0514   6.4
       ALL GOODS 343 VML09        0.0000    6.2918    4.5   6.6365   4.5   6.5956   4.1   6.9261   3.9   7.8697   3.9
FOB TRADE BAL    362 TBL           0.000     4.398    5.7    4.677   5.7    7.101   8.2   10.748  13.0   13.474  16.4
EXCH RATE(LOC/$) 267 YENDOL         0.00    -22.39  -10.0   -20.58 -10.0   -20.29 -10.0   -20.09 -10.0   -20.09 -10.0
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                                              KEY ECONOMIC INDICATORS
                                   1985-1    1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG     1990-1 %CHG
GNP DEFLATOR       95 P           0.0000   -0.0020   -0.1  -0.0084  -0.6  -0.0173  -1.   -0.0227  -1.6  -0.0230  -1.5
PRIV CONS DEFL    391 PC          0.0000   -0.0096   -0.6  -0.0175  -1.1  -0.0261  -1.   -0.0326  -2.0  -0.0342  -2.0
PRIV INV DEFL      90 PIF         0.0000   -0.0116   -1.0  -0.0150  -1.3  -0.0177  -1.   -0.0194  -1.7  -0.0196  -1.7
EXP UV INDEX US$   84 PEC         0.0000    0.1515    7.9   0.1664   8.4   0.1616   8.0   0.1602   7.7   0.1618   7.6
IMP UV INDEX US$  161 PMC          0.000    10.994    5.2   11.414   5.4   11.028   5.0   10.398   4.5   10.243   4.2
NOM WAGE PER CA    73 W            0.000    -0.369   -0.8   -0.900  -2.0   -1.396  -3.0   -1.600  -3.3   -1.483  -2.9
UNEMPLOYMENT %    103 RU          0.0000    0.0726    3.4   0.0897   4.6   0.0710   3.7   0.0013   0.1  -0.0462  -2.7
INTEREST RATE %   137 RLB         0.0000   -0.1504   -2.5  -0.0512  -0.9  -0.0325  -0.5  -0.0211  -0.4  -0.0043  -0.1
IND PROD INDEX    104 O            0.000    -2.298   -1.3   -2.746  -1.5   -2.556  -1.3   -1.986  -1.0   -1.622  -0.8
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NOTES  NOTE  CG PMSDOL AND IG ARE EXOGENOUS
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Table A.14

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US TARIFF, $ DEPREC. 10% INT. RATE +2%                JAPAN                       PROJECT LINK  FRI APR    5  17:18:41
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                                      AGGREGATE DEMAND (BILLIONS OF YEN, CURRENT PRICES)
                               1985-1   1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION   24 CV           0.   -1226.  -0.6   -2795.  -1.4   -5111.  -2.4   -7588.  -3.3   -9667.  -4.0
PUBL CONSUMPTION  155 CGV          0.    -334.  -0.9    -747.  -2.0   -1268.  -3.1   -1740.  -4.0   -2027.  -4.4
PRIV INVESTMENT    26 IFV          0.   -1125.  -2.2   -1915.  -3.5   -2367.  -4.1   -2650.  -4.3   -2747.  -4.2
HOUSING INVEST     25 IHV         0.0   -157.4  -0.9  -321.8   -1.7  -567.2   -2.9  -785.6   -3.8  -938.0   -4.2
PUBL INVESTMENT   208 IGV          0.    -273.  -1.1    -537.  -2.2    -809.  -3.3   -1040.  -4.0   -1181.  -4.3
PRIV INV CHANGE    27 IIPV        0.0   -284.0 -12.0  -250.7  -11.1  -289.1  -11.8  -256.4  -11.0  -211.3  -9.1
GOV INV CHANGE    214 IIGV     0.0000   0.0000   0.0  0.0000    0.0  0.0000    0.0  0.0000    0.0  0.0000    0.0
EXPORTS OF G&S     28 EGSV         0.   -3619.  -5.9   -4396.  -7.3   -5405.  -8.5   -6018.  -9.0   -6653.  -9.2
IMPORTS OF G&S     31 MGSV         0.   -2292.  -5.5   -2373.  -5.9   -2957.  -6.9   -3713.  -7.7   -4436.  -8.1
GROSS DOM PROD     34 GDPV         0.   -4511.  -1.3   -8359.  -2.4  -12672.  -3.4  -16285.  -4.1  -19029.  -4.5
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                                      AGGREGATE DEMAND (BILLIONS OF YEN, 1975 PRICES)
                               1985-1   1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
PRIV CONSUMPTION    3 C            0.      15.   0.0    -165.  -0.1    -517.  -0.4    -887.  -0.6   -1234.  -0.9
PUBL CONSUMPTION    5 CG       0.0000   0.0000   0.0  0.0000    0.0  0.0000    0.0  0.0000    0.0  0.0000    0.0
PRIV INVESTMENT     7 IF           0.    -518.  -1.2    -988.  -2.1   -1123.  -2.2   -1106.  -2.1    -994.  -1.8
HOUSING INVEST      8 IH        0.000   53.969   0.5  60.387    0.5  50.191    0.4  38.352    0.3  15.020    0.1
PUBL INVESTMENT    12 IG       0.0000   0.0000   0.0  0.0000    0.0  0.0000    0.0  0.0000    0.0  0.0000    0.0
PRIV INV CHANGE    13 IIP         0.0   -197.0 -11.3  -166.4  -10.1  -185.1  -10.6  -155.7   -9.5  -118.1   -7.4
GOV INV CHANGE    212 IIG      0.0000   0.0000   0.0  0.0000    0.0  0.0000    0.0  0.0000    0.0  0.0000    0.0
EXPORTS OF G&S     14 EGS          0.   -1915.  -3.6   -2770.  -5.0   -3096.  -5.4   -3039.  -5.0   -3010.  -4.8
IMPORTS OF G&S     17 MGS         0.0    200.0   1.0   143.2    0.4   -45.2   -0.1  -158.1   -0.4  -210.9   -0.6
GROSS DOM  PROD    20 GDP          0.   -2850.  -1.2   -4172.  -1.7   -4826.  -1.8   -4994.  -1.8   -5131.  -1.8
-----------------------------------------------------------------------------------------------------------------------
                                   BALANCE OF PAYMENTS (BILLIONS OF U.S. DOLLARS, CURRENT PRICES)
                               1985-1   1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
EXPORTS SITC 0-1 329 VXL01     0.0000   0.0358   2.2  0.0283    1.6  0.0277    1.5  0.0339    1.7  0.0160    0.8
        SITC 2+4 330 VXL24     0.0000   0.1614  11.2  0.2053   13.1  0.1871   10.9  0.1569    8.4  0.1951    9.4
        SITC 3   331 VXL3      0.0000   0.0434   7.2  0.0409    6.3  0.0393    5.6  0.0390    5.2  0.0411    5.1
        SITC 5-9 332 VXL59     0.0000   8.5315   4.0  4.9404    2.2  2.1932    0.9  1.8110    0.7  2.2051    0.8
       ALL GOODS 333 VXL09     0.0000   8.7720   4.0  5.2150    2.3  2.4474    1.0  2.0410    0.8  2.4595    0.9
IMPORTS SITC 0-1 339 VML01      0.000    0.309   1.7   0.057    0.3  -0.338   -1.5  -0.797   -3.1  -1.178   -4.0
        SITC 2+4 340 VML24     0.0000   1.3275   5.1  1.6142    5.9  1.3866    4.8  1.0161    3.1  0.7832    2.2
        SITC 3   341 VML3      0.0000   1.7441   3.3  1.1653    2.1  0.8793    1.5  0.6718    1.0  0.5964    0.8
        SITC 5-9 342 VML59     0.0000   2.7454   6.5  3.0366    6.6  2.8653    5.9  2.8532    5.1  3.0318    4.8
       ALL GOODS 343 VML09     0.0000   6.1261   4.4  5.8733    4.0  4.7936    3.0  3.7441    2.1  3.2332    1.6
FOB TRADE BAL    362 TRL        0.000    2.646   3.4  -0.658   -0.6  -2.346   -2.7  -1.703   -2.1  -0.774   -0.9
EXCH RATE(LOC/$) 267 YENDOL      0.00   -22.39 -10.0  -20.58  -10.0  -20.29  -10.0  -20.09  -10.0  -20.09  -10.0
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                                                  KEY ECONOMIC INDICATORS
                               1985-1   1986-1 %CHG    1987-1 %CHG    1988-1 %CHG    1989-1 %CHG    1990-1 %CHG
GNP DEFLATOR       95 P        0.0000  -0.0023  -0.2 -0.0100   -0.7 -0.0224   -1.6 -0.0336   -2.3 -0.0410   -2.7
PRIV CONS DEFL    391 PC       0.0000  -0.0102  -0.7 -0.0199   -1.3 -0.0324   -2.0 -0.0448   -2.7 -0.0535   -3.1
PRIV INV DEFL      90 PIF      0.0000  -0.0122  -1.1 -0.0169   -1.5 -0.0219   -1.9 -0.0263   -2.3 -0.0289   -2.5
EXP UV INDEX US$   84 PEC      0.0000   0.1497   7.8  0.1589    8.0  0.1444    7.1  0.1314    6.3  0.1213    5.7
IMP UV INDEX US$  161 PMC       0.000   10.935   5.1  10.983    5.2  10.003    4.6   8.840    3.8   8.119    3.4
NOM WAGE PER CA    73 W         0.000   -0.406  -0.9  -1.063   -2.4  -1.815   -3.9  -2.372   -4.9  -2.611   -5.2
UNEMPLOYMENT %    103 RU       0.0000   0.0814   3.0  0.1167    6.0  0.1208    6.2  0.0813    3.6  0.0040    0.2
INTEREST RATE %   137 RLB      0.0000  -0.1523  -2.6 -0.0575   -1.0 -0.0451   -0.8 -0.0396   -0.7 -0.0251   -0.4
IND PROD INDEX    104 O         0.000   -2.691  -1.5  -4.026   -2.1  -4.926   -2.5  -5.227   -2.6  -5.407   -2.5
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NOTES  NOTE  CG PWSDOL AND IG ARE EXOGENOUS
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STATEMENT OF DR. CRAIG K. ELWELL, ANALYST IN ECONOMETRICS, ECONOMICS DIVISION, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS, WASHINGTON, DC

The **CHAIRMAN**. Mr. Elwell.

Mr. **ELWELL**. Thank you, Mr. Chairman.

At the request of this committee, CRS conducted an analysis of an import surcharge. The specific proposal considered was a 20-15-10 percent declining rate ad valorem tariff, in place for 3 years. That is, it would be temporary. Economic effects for 3 years beyond that point were looked at. Thus the complete time interval examined was 1986 through 1991.

This analysis was done using the Data Resources, Inc. [DRI] econometric model. Three global assumptions were imposed on the analysis that was done. No. 1, it was assumed that there would be no foreign retaliation. No. 2, it was assumed that there would be no exemptions from the tariff. That is, all import goods and services would be taxed. And finally, global assumption number three was that there would be no active monetary policy response to the tariff.

Those assumptions are used to simplify the analysis, to better isolate the effects of the tariff, and see more clearly what the tariff would do to the economy.

In general, when interpreting the results of this CRS study of a tariff, I would caution that you pay attention to the broad directions, and magnitudes of change. I think there is a certain pretense of precision that goes with presenting econometric results and I don't want to pretend that every decimal point is indeed what would occur.

Let me summarize briefly what this study concluded. A tariff is a tax whose burden would be borne in a fairly substantial way by the American economy. That burden would take the form of higher prices—that is, the rate of inflation would certainly be increased; and lower output—that is, real GNP would certainly fall relative to a situation without the tariff. This fall of real GNP means any gains in output in employment made by import competing industries would seem to be more than offset by losses in the wider economy. This conclusion was true without retaliation, and I think it is clear that those burdens would, indeed, be far greater if there were any retaliation from foreign governments.

It is noted in the CRS study that the precise consequences of a tariff is of course, very sensitive to what the exchange does and what degree of foreign exporter absorption of the tariff occurs. But I don't think either necessarily changes the basic conclusions.

Certainly the tariff would also be borne in a fairly substantial way by the rest of the world. Under one scenario it was demonstrated that the rest of the world could, indeed, be made to pay a fairly hefty share of that tariff, if there was significant absorption.

A third conclusion, and I think perhaps the more interesting one, is that the tariff does not seem to lead to any substantial, sustained improvement in the balance of trade. It is indicated that a tariff may, in fact, lead to a substantial appreciation, relative to the baseline scenario, of the exchange rate. And that works, of course, to offset the import reducing effects of the tariff, but it also works to reduce exports.

What the econometric simulations indicate is that the longer term output dampening effects of a tariff were the result of this exchange rate appreciation, channeling through from reduced exports. In general, this CRS study strongly suggests that a tariff on imports would pose substantial risks for U.S. exports whether that risk comes through retaliation, reduced foreign income, or an appreciating exchange rate.

Thank you.

[The prepared statement of Dr. Elwell follows:]

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

February 15, 1985

TO : Senate Finance Committee
Attention: Leonard Santos, Trade Counsel

FROM : Craig K. Elwell
Analyst in Econometrics
Economics Division

SUBJECT : Preliminary Results of Econometric Analysis of Macroeconomic Effects of a 20 Percent, Three-Year Ad-Valorem Tariff

This is in partial reply to your request for an econometric analysis of a 20 percent import tariff. The results reported here are preliminary and could be subject to some adjustment as the simulation is examined further. It seems quite likely, however, that these adjustments would be relatively small and not dramatically change the basic results of this simulation exercise. Nevertheless, I would counsel that you focus your attention on the broad magnitudes and direction of change to macroeconomic variables that result from this policy simulation. The Data Resources Inc. (DRI) macro model was used to do this simulation. I would also point out that the results presented here implicitly assume that there is no policy reaction from the monetary authority and no foreign retaliation to the tariff. The occurrence of either would significantly effect the outcome reported here.

Table 1, below, presents the effects on key measures of macroeconomic activity relative to the base case and subject to the conditions just noted, of 20 percent ad valorem tariffs on all imported goods. (The tax revenues collected by the tariff are reflected in the change in the level of Federal indirect business taxes.) The important conclusions to be drawn from those results are:

- A 20 percent tariff would raise between $75 and $85 billion dollars in tariff revenue in each of the three years it is in effect.
- The added tax revenue created by the tariff is achieved at the price of a reduced level of real GNP and an increase in the rate of inflation. At peak effect, real GNP would fall about 1.3 percent in 1988 and the inflation rate would rise about 1.6 percentage points in 1986.
- Revenue inflows from the tariff would lead to a reduction in the Federal budget deficit of $64 to $73 billion dollars annually for each of the three years the tariff is in effect. Deficit reduction so achieved, raises U.S. interest rates and the yield on 3-month Treasury bills is up 0.7 percentage points by 1988.
- By 1988, net exports (i.e., exports minus imports) would increase nearly $80 billion dollars. This improvement reflects the net effect of a modest increase in the value of exports and a more substantial reduction in the value of imports. (It is interesting to note that the increase in exports is totally a result of higher export prices whereas the decrease in imports is primarily the consequence of reduction in the real volume of imports.)

The Question of Interest Rates and the Exchange Rate

Two aspects of these results might be questioned by some analysts: the rise of interest rates and the rise of the exchange rate. Although, the model's conclusion for these variables are plausible and certainly defensible, it might be useful to see the sensitivity of the results to constraining the level of interest rates and the exchange rate to the base case levels. This would mean that by 1988, the yield on 3-month Treasury bills would be 0.7 percentage points lower and the exchange rate 13 percent lower. The results of this simulation are presented in table 2. The important conclusions to be drawn from those results are:

- If interest rates and the exchange rate do not rise with imposition of the tariff, real GNP would fall by only about one-half as much in 1988. There is little difference of effect in 1986 and 1987 (most of this effect is attributable to the lower level of interest rates).
- Stronger demand growth leads to an additional 0.5 percentage point boost in the inflation rate in 1988.

- Stronger economic activity, lower interest expense, and increased tariff revenues contribute about equally to lowering the budget deficit an additional $15 billion dollars in 1988.
- The improvement in net exports is about $15 billion smaller by 1988. A lower exchange rate does boost exports, but the higher income attributable to lower interest rates leads to a more sizable boost in imports.

The Question of Absorption

The point has been raised by some analysts that the very high level of the dollar's exchange rate has led to a significant stretching of profit margins for many importers to the U.S. market (i.e., they are earning significant "windfall profits"). In this environment, it is argued, importers would likely be inclined to "absorb" some of the tariff, that is, reduce the price of their products so as to maintain their share of the U.S. market. Beyond whether it would occur, the difficult issue is judging the magnitude of absorption that might occur.

To approach this issue, a second simulation was constructed, like the first, but with the strong assumption that 50 percent of the tariff is absorbed by importers through lowering prices for their goods. This means that if the price to the U.S. buyer of a $100 import with the 20 percent tariff would have been $120, then with 50 percent absorption by the importer, it would now be $110. The results of this simulation are presented in table 3. The important conclusions to be drawn from those results are:

- Absorption will significantly limit the rise in the rate of inflation associated with imposition of the tariff. In this simulation, the added rate of increase in the CPI caused by the tariff is halved.
- Absorption of the tariff does not substantially alter its effect on real GNP and the unemployment rate.
- There is no significant change in the magnitude of tax receipts collected by the tariff nor any significant change in the degree of reduction in the Federal deficit.

- Absorption leads to a further improvement in net exports in 1986, but this gain vanishes by 1988. By 1988, absorption of half the tariff would lead to importers regaining approximately two-thirds of the real import volume that was lost without absorption.

In interpreting all of these simulation studies, I would urge you to be mindful that the real world effects of an import tax are much more problematic than suggested above, because of the uncertainty of foreign retaliation which could significantly alter the results.

The results of the simulation of the tariff declining from 20 percent to 15 percent to 10 percent over three years should be available to you within the next ten days.

TABLE 1. The Macroeconomic Consequences of a Three-Year, 20 Percent Tariff in the Value of Imported Goods

	1986	1987	1988
Real GNP (billions of 1972 $)			
A	1731.1	1778.8	1835.1
B	1739.3	1797.3	1858.5
D	-8.3	-18.5	-23.3
%	-0.5	-1.0	-1.3
Unemployment Rate (percent)			
A	7.46	7.60	7.52
B	7.33	7.24	7.10
D	0.13	0.36	0.42
%	1.8	5.0	5.9
Consumer Price Index (annual rate)			
A	5.5	5.4	5.2
B	3.9	4.6	5.2
D	1.6	0.7	0.0
%	40.2	15.9	0.0
3-Month Treasury Bill (annual yield)			
A	8.64	9.89	9.82
B	8.47	9.40	9.10
D	0.17	.48	0.72
%	1.9	5.1	7.9
Indirect Business Taxes (billions of $)			
A	137.1	142.6	160.7
B	60.3	63.1	75.6
D	76.8	79.5	84.5
%	127.3	126.0	111.8
Federal Budget Deficit (billions of $)			
A	-134.4	-153.1	-146.2
B	-206.7	-217.0	-214.0
D	72.3	63.9	67.9
%	-35.0	-27.4	-31.7
Net Exports (billions of $)			
A	-84.3	-59.9	-48.7
B	-104.8	-118.7	-128.2
D	20.6	58.0	79.4
%	-19.5	-44.6	-54.2
Exchange Rate (Index)			
A	1.045	1.033	1.077
B	1.038	0.985	0.957
D	0.007	0.048	0.120
%	0.6	4.9	12.6

Key: A = Economy with 20 percent tariff
B = Base Case
D = A - B
% = (A - B)/B times 100

TABLE 2. The Macroeconomic Consequences of a Three-Year, 20 Percent Tariff in the Value of Imported Goods, With Interest Rates, and the Exchange Rate Unchanged from the Base Case

	1986	1987	1988
Real GNP (billions of 1972 $)			
A	1731.3	1781.1	1845.9
B	1739.3	1797.3	1858.5
D	-8.0	-16.2	-13.6
%	-0.5	-0.9	-0.7
Unemployment Rate (percent)			
A	7.46	7.56	7.34
B	7.33	7.24	7.10
D	0.13	0.32	0.24
%	1.7	4.4	3.3
Consumer Price Index (annual rate)			
A	5.5	5.5	5.7
B	3.9	4.6	5.2
D	1.6	0.8	0.5
%	40.2	18.3	8.8
3-month Treasury Bill (annual yield)			
A	8.47	9.40	9.10
B	8.47	9.40	9.10
D	same	same	same
%	same	same	same
Indirect Business Taxes (billions of $)			
A	138.1	143.8	164.7
B	60.3	63.1	75.6
D	77.8	80.7	87.1
%	129.0	127.9	118.1
Federal Budget Deficit (billions of $)			
A	-133.1	-149.4	-131.6
B	-206.7	-217.0	-214.0
D	73.6	67.6	82.4
%	-35.6	-31.2	-38.5
Net Exports (billions of $)			
A	-84.4	-68.3	-63.5
B	-104.8	-118.7	-128.2
D	20.5	50.4	64.6
%	-19.5	-42.5	-50.4
Exchange Rate (Index)			
A	1.044	0.988	0.952
B	1.038	0.985	0.957
D	0.006	0.003	-0.004
%	0.5	0.3	-0.5

Key: A = Economy with 20 percent tariff
B = Base Case
D = A - B
% = (A - B)/B times 100

TABLE 3. The Macroeconomic Consequences of a Three-Year, 20 Percent Tariff with 50 Percent Absorption in the Price of Imports

	1986	1987	1988
Real GNP (billions of 1972 $)			
A	1734.2	1782.1	1836.1
B	1739.3	1797.3	1858.5
D	-5.1	-15.2	-22.4
%	-0.3	-0.8	-1.2
Unemployment Rate (percent)			
A	7.41	7.54	7.53
B	7.33	7.24	7.10
D	0.08	0.30	0.42
%	1.1	4.2	5.9
Consumer Price Index (annual rate)			
A	4.7	4.9	5.0
B	3.9	4.6	5.2
D	0.8	0.2	-0.2
%	20.7	5.3	-3.9
3-Month Treasury Bill (annual yield)			
A	8.60	9.75	9.61
B	9.47	9.40	9.10
D	0.12	0.35	0.51
%	1.5	3.7	5.6
Exchange Rate (Index)			
A	1.052	1.055	1.100
B	1.032	0.985	0.957
D	0.013	0.069	0.143
%	1.3	7.0	15.0
Net Exports (billions of $)			
A	-65.8	-56.6	-48.5
B	-104.8	-118.7	-128.2
D	39.0	66.1	79.7
%	-37.2	-55.7	-62.2
Indirect Business Taxes (billions of $)			
A	137.9	143.5	160.1
B	60.3	63.1	75.6
D	77.5	50.4	84.5
%	128.6	127.4	111.7
Federal Budget Deficit (billions of $)			
A	-133.4	-148.4	-144.2
B	-206.7	-217.0	-214.0
D	73.3	68.6	69.9
%	-35.4	-31.6	-32.6

Key: A = Economy with 20 percent tariff
B = Base Case
D = A - B
% = (A - B)/B times 100

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Washington, D.C. 20540

April 10, 1985

TO : Senate Finance Committee
Attention: Mr. Leonard Santos, Trade Counse

FROM : Craig K. Elwell
Analyst in Econometrics
Economics Division

SUBJECT : Econometric Analysis of the Macroeconomic Consequences of a Three-Year, 20 Percent, 15 Percent, and 10 Percent, Declining Rate Ad-Valorem Tariff on Imported Goods.

The "twin deficit problem" is much on the minds of policy makers in Congress. Despite a strong economic recovery, the Federal budget deficit remains large at about $175 billion in 1984, and nearly 5 percent of GNP; and most analysts see no prospect for budget deficit reduction unless, substantial fiscal tightening is forthcoming. Further, over the last two years a second deficit "problem" has emerged as our merchandise trade balance (exports of goods minus imports of goods) has gone from deficit of $36.5 billion in 1982 to an unprecedented $107.6 billion deficit in 1984. Together, these deficits are perceived as posing a major threat to our economic well-being.

It is also generally understood that the deficits are related. Large Federal deficits during a vigorous economic recovery have likely kept interest rates in the U.S. above those in a slower growing world economy. This interest rate spread has lead to a strong demand for high yielding dollar denominated assets and, in turn, a strong demand for the dollars needed to buy them. This bids up the price of the dollar in terms of most foreign currencies, that is, the exchange rate rises. A rising dollar exchange rate (up nearly 35 percent on a trade-weighted basis since 1981) has raised the effective price of our exports and lowered the effective price of imports to the U.S. market and contributed to the trade deficit. Thus, it is believed, substantially reducing the budget deficit is likely to lead, with a time lag, to an improvement in the trade deficit.

Sharp concern for the danger twin deficits may pose for the U.S. economy has prompted proposals that the U.S. levy a tariff on imports; that we "cut the Gordian Knot" and move directly to counter the consequences of the strong dollar and raise added revenue to reduce the budget deficit.

This report is the response to your request for an analysis of the macroeconomic consequences of imposition of a 20 percent, 15 percent, and 10 percent declining rate ad-valorem tariff on the value of imported goods. The analysis assumes the tariff is in place from 1986 through 1988 and considers possible consequence through the year 1991. The econometric simulations were performed with the Data Resources, Inc. (DRI) macroeconometric model. All of the simulations of the tariff assume that there is no foreign government retaliation, no exemptions from the tariff, and no active monetary policy response to the tariff.

In interpreting the detailed results, it is most prudent and useful to focus on the direction and broad magnitudes of change of economic variables that the DRI model indicates are evoked by this type of policy action. It is also wise to bear in mind that the precise results reported here suggest an exactitude that is illusory and that they are highly sensitive to three critical uncertainties: foreign retaliation, the path of the dollar exchange rate, and the degree of exporter absorption of the tariff.

Despite these uncertainties, the following general conclusions are suggested by this research:

- A tariff is a tax whose burden will likely be borne to a substantial degree by the American economy in the form of higher prices and reduced output and employment. Any gains in output and employment made by import competing industries are outweighed by losses in the wider economy. This is true without retaliation, thus, any degree of retaliation increases the cost of the tariff to the U.S.

- The tariff burden will also partially fall on our trading partners (at least temporarily) in the form of reduced export sales to the U.S. market and reduced output abroad. To the extent the rest of the world pays this tax, the burdens on the U.S. economy are reduced.

- A temporary tariffs lead to no permanent improvement in the balance of trade. It is indicated that a tariff could lead to a substantial rise in the dollar's exchange rate, offsetting much of the fall of imports initially caused by the tariff, but also reducing substantially U.S. exports. In general, a tariff would seem to pose substantial risks for U.S. exports whether from foreign retaliation, an appreciating dollar, or reduced world income.

- A tariff can raise a substantial amount of revenue to apply toward budget deficit reduction. However, given that a tariff has no strong advantage (and perhaps some disadvantages) over other revenue raising vehicles in its ability to improve the balance of trade, is it the best economic vehicle available for raising revenue and reducing the "twin deficits?"

Conceptual Background

A tariff on imports is a tax whose burden will be carried by American producers and consumers to the degree (after tariff) the purchase price of imported goods rises; or a tax on foreign exporters and income if exporters lose sales and reduce the price of their goods, that is, absorb some of the tariff. Whether that burden falls exclusively on U.S. citizens and businesses or foreign citizens and businesses or is (as is very likely) shared by both, some will be made worse off and some will gain.

If American producers and consumers bear some or all of the tax burden of the tariff two general effects will operate on the economy. First, because of the rising price of imports to the U.S. buyer, to some degree, U.S. goods will be substituted for foreign goods; leading to some increase in the output of industries that compete with imports. This output-increasing substitution effect is often the foundation of the arguments of advocates of a tariff.

A second effect, an income effect, is also likely to accompany the imposition of a tariff. A tariff would raise prices of domestic goods relative to those of imports, directly by its effect on the price of imports, and indirectly by removal of some competitive pressure on the prices of many domestic goods. This means that the real income of the economy has been reduced, reducing the demand for all goods, foreign and domestic.

Whether the income or substitution effect is predominant will depend on how responsive (i.e., elastic) the demand for imports is to their higher price with a tariff. If relatively unresponsive (i.e., inelastic), the income effect prevails causing a net reduction in output and employment in the U.S. The larger the income effect on the U.S. economy, that is, the more unresponsive imports are to an increase in price, the greater the burden of the tax paid by the U.S. and the less of the burden paid by the rest of the world. Of course, if import demand is quite responsive to price changes (i.e., elastic) then these outcomes are reversed -- U.S. output rises and the rest of the world pays more of the burden of the tariff. Most evidence suggests that the U.S. demand for imports (on average) is probably relatively inelastic to relative price changes in the short-run, but likely become more elastic in the long-run (for a summary of research results of this issue see: Robert Stein, Jonathan Francis, and Bruce Schumacher; Price Elasticities in International Trade; Macmillian of Canada, 1977).

The general qualitative expectation of, at least, the initial macroeconomic effects of a tariff paid in part by the domestic economy and used to reduce the Federal deficit are: an increase in the price level and an attendant but vanishing acceleration of the rate of inflation; and, a reduction in real GNP as the cut in real income outweighs the positive substitution of domestic output for imports. The trade deficit should initially fall, but a rising exchange rate would likely work to offset this trend, perhaps hurting exports. The budget deficit will also fall as tariff revenues flow into the treasury (of course this effect vanishes when the tariff is removed).

The substantive effect of a tariff will depend on three factors: absorption, retaliation, and the exchange rate.

Absorption: How would our expectations change if we anticipated that foreign producers will pay (absorb) all or a substantial portion of the tariff levy by lowering their export prices for imports. Import prices to the economy would fall, improving our terms of trade. In the extreme of complete absorption, the economy would receive the same real bundle of imports at a lower price. In addition, the Treasury would be getting foreign producers (exporters) to pay a portion, or with complete absorption, all of the tariff (tax). To the extent that absorption occurs, it will limit the inflationary effect of the tariff and reduce the depressing effect of that action on real GNP. In the extreme, with complete absorption the tariff might not have any direct effect on domestic output, employment and prices. Of course, there might be some indirect effect if reduced foreign profits lead to reduced foreign income, and this feeds back to reduce demand for U.S. exports. While absorption, if it occurs, limits the negative impacts of a tariff on the U.S. economy (at least in the short-run) it is making our trading partners worse off.

Retaliation: Retaliation is a major risk that must accompany any imposition of a tariff. If our principal trading partners react on a substantial scale to our action with their own tariffs, such retaliation would reduce our export sales and thus reduce output and employment over and above what our tariff alone would have caused. Moreover, with retaliation, even potential, temporary near term improvements in our trade balance become far more problematic. A tariff imposition clearly increases the economic risk our export industries must face.

The Exchange Rate: How the exchange rate of the dollar responds to the imposition of a tariff will likely greatly influence the wider economic consequences of that policy. Traditional economic analysis would suggest that, given some sensitivity of import demand to price, the tariff leads to an initial increase in the balance of trade as import sales fall. This, however, also likely leads to a reduction in the supply of dollars to the foreign exchange market and, other things unchanged, should cause the dollar to appreciate in value -- that is the exchange rate rises. A rising dollar will, of course work to reverse the favorable effects of the tariff (without retaliation) on the trade balance as a rising dollar stimulates the demand for imports and dampens the demand for exports. Economists have long known that a tax on imports, in a system of flexible exchange rates, may become, in effect, a tax on exports.

Of course, as many economists will point out, the exchange rate has been little influenced by the build up of a large trade deficit over the last four years. Rather, the capital markets not the goods markets have "called the tune," as strong and continuing foreign demand for dollar denominated assets has pushed the dollar's exchange rate ever higher. How would capital markets respond to a tariff? Would they see it as a sign of continued dollar strength or impending weakness? Would the capital markets' response keep the exchange rate from rising in response to the positive swing in the trade balance evoked by the tariff? These questions cannot be answered here but they should be kept in mind because how the exchange rate moves will likely greatly influence the consequences, particularly the longer term consequences of such a tariff on our trade balance and the wider economy.

Simulation Results

What are the likely macroeconomic results of imposition of a three-year, 20 percent, 15 percent, and 10 percent declining ad-valorem tariff on all imported goods? Towards an answer to that question, a series of econometric simulations of such a policy was made. The simulation results presented here are conditional on two global assumptions: the Federal Reserve takes no active monetary policy response to the tariff and there is no foreign retaliation. (If the Federal Reserve responded with monetary stimulus to a tariff, it would likely limit the repercussions of the tariff on output but likely add to inflation any pressures. On the other hand, if the Federal Reserve responded with monetary restraint and offset the tariff-induced rise of the price level, it would add to the negative output effects of the tariff but reduce the inflation effects.)

Three simulations of the 20-15-10 tariff are considered. The first looks at the tariff subject only to the global assumptions just noted. The second and third encompass a sequence of progressively more optimistic assumptions as regards first interest rates and the exchange rate, and then, the degree of tariff absorption. These subsequent simulations should not be judged to be more likely outcomes than those in the first, but rather are undertaken to reveal the sensitivity of the macroeconomic results to alternative movements of these important variables. A fourth simulation is also presented which depicts the macroeconomic effects of an increase in personal income taxes that raises the same amount of tax revenue as the tariff does. This will provide some appreciation of the differences in macroeconomic effect of a perhaps more conventional tax levy.

The Data Resources, Incorporated, (DRI) macroeconometric model of the U.S. economy was used to do all of these simulation exercises. The DRI model embodies what has been termed a "mainline" representation of macroeconomic behavior, a form which is supported in broad detail by the preponderance of empirical evidence. It should be pointed out that the DRI model has no explicit modeling of international capital flows, therefore if one has a strong a-priori judgement of how the imposition of a tariff will effect that flow, then it would have to be imposed on the model solution. Finally, the results of this econometric exercise are not presented as forecasts, but rather as indicators of the probable direction and magnitude of change of important measures of macroeconomic performance in response to imposition of a three-year, 20 percent-15 percent-10 percent declining rate tariff. The simulution interval extends from 1986 through 1991 with the tariff assumed to be in effect for the first three years of that time period. The tariff simulations are imposed on a "baseline" simulation and all the economic effects of that action are judged relative to the "baseline" solution. The "baseline" used in this study was DRI's basic long-term projection (made in February 1985 and titled TRENDLONG 0285). That projection abstracts from the swings of the business-cycle, providing what DRI sees emerging "on average" over the next several years.

Case 1: Table 1, below, presents the effects, subject to the global assumptions just noted, on key measures of macroeconomic activity, as interpreted by the DRI model, of the 20-15-10 tariff on all imported goods. The tariff is assumed to be in effect from 1986 through 1988. (The tax revenues collected by the tariff are reflected in the change in the level of Federal indirect business taxes.) The important conclusions to be gleaned from those results are:

- Real GNP falls below baseline for the whole six year interval examined and the divergence grows over time. The fall is 0.5 percent below baseline in 1986 and declines to 2.0 percent below baseline by 1991. In the early years the reduction of real GNP is primarily the direct consequence of lower real income caused by the tariff. In the latter years, however, the reduction is the consequence of lower real net exports caused by a higher exchange rate.

- Inflation, as measured by the CPI, increases sharply in 1986, up 1.6 percentage points. But the inflation bulge is temporary and nearly gone by 1987, with the inflation rate up only 0.4 percentage points. From 1988 to 1991, inflation dips below baseline, as much as 1.4 percentage points, as weaker demand growth reduces price pressures.

- Net exports (exports minus imports), rise to a peak improvement of about $61 billion in 1988. This gain deteriorates in the subsequent two years and by 1991 net exports has actually fallen 9.2 percent below baseline. The change in net exports reflects the combined effect of a modest initial rise then followed by a substantial fall below baseline of exports, and a sustained fall of imports. Real exports fall progressively further below baseline over the six year time span and real imports initially fall but then move above baseline by 1990. By 1991, net real exports have fallen about $35 billion, representing about 85 percent of the fall-off of real GNP in that year.

- The exchange rate of the dollar increases steadily, standing about 21 percent above baseline in 1990 and 1991. It is this dollar appreciation that substantially explains the decline of net exports and, in turn, the reduction of real GNP

TABLE 1. The Macroeconomic Consequences of a Three-Year, 20 Percent, 15 Percent, and 10 Percent Declining Rate Ad-Valorem Tariff on all Imported Goods

	1986	1987	1988	1989	1990	1991
Real GNP (billion of 1972 $)						
A	1730.7	1780.9	1842.2	1902.0	1951.8	1996.0
B	1739.3	1797.3	1858.5	1920.3	1980.4	2037.1
D	-8.6	-16.4	-16.3	-18.3	-28.6	-41.1
%	-0.5	-0.9	-0.9	-1.0	-1.4	-2.0
Consumer Price Index (percent change)						
A	5.5	5.0	4.7	4.0	4.6	4.8
B	3.9	4.6	5.2	5.4	5.7	5.7
D	1.6	0.4	-0.5	-1.4	-1.0	-0.9
%	40.1	7.7	-10.1	-25.7	-18.1	-15.1
Exports (billions of $)						
A	425.7	484.7	532.1	567.5	608.4	665.4
B	416.6	471.0	529.8	594.2	669.0	755.2
D	9.1	13.7	2.3	-26.7	-60.6	-89.7
%	2.2	2.9	0.4	-4.5	-9.1	-11.9
Imports (billions of $)						
A	510.0	549.9	599.4	660.0	737.5	809.2
B	521.5	589.7	658.0	725.3	804.9	886.8
D	-11.5	-39.8	-58.6	-65.3	-67.4	-77.6
%	-2.2	-6.7	-8.9	-9.0	-8.4	-8.7
Net Exports (billions of $)						
A	-84.3	-65.2	-67.3	-92.6	-129.1	-143.8
B	-104.8	-118.7	-128.2	-131.1	-135.9	-131.6
D	20.5	53.5	60.9	38.5	6.8	-12.1
%	-19.6	-45.1	-47.5	-29.4	-5.0	9.2
Real Exports (billions of 1972 %)						
A	158.9	170.5	178.8	185.2	192.4	202.3
B	159.0	171.0	182.1	194.0	266.9	220.7
D	0.0	-0.6	-3.3	-8.7	-14.5	-18.4
%	0.0	-0.3	-1.8	-4.5	-7.0	-8.4

(continued)

Key: A = Economy with 20 - 15 - 10 percent tariff
B = Base Case
D = A - B
% = (A-B)/B times 100

TABLE 1. The Macroeconomic Consequences of a Three-Year, 20 Percent, 15 Percent, and 10 Percent Declining Rate Ad-Valorem Tariff on all Imported Goods -- continued

	1986	1987	1988	1989	1990	1991
Real Imports (billions of 1972 $)						
A	178.2	179.9	191.8	209.7	229.4	241.3
B	183.0	193.6	202.4	209.7	217.6	225.4
D	-4.8	-13.6	-10.6	0.0	11.9	15.9
%	-2.6	-7.0	-5.2	0.0	5.4	7.1
Real Net Exports (billions of 1972 $)						
A	-19.3	-9.5	-13.0	-24.5	-37.1	-39.1
B	-24.0	-22.6	-20.3	-15.8	-10.7	-4.7
D	4.7	13.1	7.3	-8.7	-26.3	-34.4
%	-19.7	-58.0	-36.1	55.3	245.5	730.1
Federal Budget Deficit (billions of $)						
A	134.1	169.1	178.9	220.9	219.0	224.5
B	206.7	217.0	214.0	210.1	195.9	186.0
D	-72.6	-47.9	-35.1	10.8	23.0	38.5
%	-36.1	-22.1	-16.4	5.2	11.8	20.7
3-Month Treasury Bill Rate (percent)						
A	8.67	9.89	9.72	8.73	7.50	7.04
B	8.47	9.40	9.10	8.19	7.31	7.05
D	.20	.48	0.61	0.53	0.20	-0.02
%	2.3	5.1	6.7	6.5	2.7	-0.2
Exchange Rate (1970 = 1)						
A	1.045	1.033	1.066	1.092	1.086	1.070
B	1.038	0.985	0.957	0.929	0.899	0.886
D	0.007	0.047	0.109	0.164	0.187	0.886
%	0.7	4.8	11.4	17.6	20.8	20.8

Key: A = Economy with 20 - 15 - 10 percent tariff
B = Base Case
D = A - B
% = (A-B)/B times 100

below baseline in the latter part of the time interval. Part of the dollar's rise is due to interest rates rising in response to the price shock caused by the tariff. But the primary cause is the substantial increase in net exports resulting from the tariff. The reduction of imports reduces the supply of dollars on the foreign exchange markets and the dollar's foreign currency price rises. In the context of this model, by 1991, the depressing effect of the higher exchange rate on net exports is greater than the stimulative effect on the wider economy of removing the tariff. (This is an area were one should forcus on the direction and broad magnitudes of change: a substantial decrease of imports, a substantial rise of the exchange rate above baseline, and a substantial fall of exports below baseline.)

- The tariff would raise, given the price and income elasticities of import demand in the DRI model, approximately $75 billion in 1986, $60 billion in 1987, and $45 billion in 1988. This, in turn, would lead to reductions in the Federal budget deficit of $70 billion, $48 billion, and $35 billion in those years respectively. The fact that tariff receipts do not equally reduce the deficit reflects the reduction in other tax receipts caused by the greater fall off of economic activity in these latter years.

The Critical Question of Interest Rates and the Exchange Rate

From the simulation results reported above, we see that the behavior of the exchange rate and, to a lesser extent, interest rates play a critical role in determining the long-term consequences of a tariff on imported goods. That the exchange rate would be higher in response to the tariff is consistent with how traditional economic thinking would expect the exchange rate to move given that the tariff moderately raises domestic interest rates and substantially increases net exports (by reducing imports). One certainly does not have to believe the swing of net exports and rise of the exchange would be of the precise degree indicated by the simulation to be impressed by the economic logic of that result and see that such a tariff would carry a large risk of a substantial rise of the exchange rate (above baseline), and substantial subsequent fall of exports (below baseline). Nevertheless, as was mentioned earlier, the exchange rate has shown little inclination to conform to traditional thinking. It might be useful to consider reasons why the exchange rate might not rise, or why it might in fact, fall, and what this might mean for the macroeconomic consequences of a tariff. Some argue that a tariff program aimed at deficit reduction, would be accompanied by stimulative (accomodative) monetary policy. Such a policy would lower interest rates, at least for the near term, and that in turn, would offset some of the more directly depressing effects of the tariff on the real economy, but it would also lower the exchange rate as foreign capital flowed away from lower domestic interest rates. A lower exchange rate, so achieved of course, would work to improve net exports. Thus, if a policy of monetary stimulus, (relative to baseline) were assumed, it is likely that some signicant amount of the negative effects on the economy evident in table 1 could be removed. It seems, however, that, given the size of the exchange rate appreciation found in table 1, the degree of monetary stimulus would have to be very substantial, perhaps enough to lower interest rates in the neighborhood of 2 to 4 percentage points below baseline by 1991, to (more or less) keep the exchange rate from rising above baseline. With the application of so sizable a monetary stimulus, one must become concerned with the appearance of a big increase in inflation. There is little doubt that monetary stimulus would reduce the negative near-term effects of a tariff on the real economy. The uncertainties are: would the Federal Reserve take on a more stimulative stance, to what degree would it do so, and when and how much would added inflation begin to hurt the economy.

A far more problematic issue, regarding how the exchange rate would move in response to imposition of a tariff like that being considered here, is the response of international capital markets to that policy. As was pointed out earlier, many economists now think that it is international capital flows, not the international flow of goods, that dictates exchange rate movements today. Whether in pursuit of high rates of return or a "safe haven," foreign capital has flowed into the U.S. on a massive scale in recent years. This sharp rise in the demand for dollar denominated assets has, it is argued, pushed the dollar exchange rate steadily higher; and that, in turn, has also pushed the trade deficit ever higher.

A substantial capital market response to a tariff might dramatically affect how interest rates and the exchange rate move and, therefore, significantly affect how the economy moves. If, however unlikely, the foreign exchange market viewed imposition of a tariff in a very positive light, then more capital might flow into the U.S., raising the exchange rate still further and lowering domestic interest rates. Lower interest rates would likely give a boost to the wider economy but still a higher exchange rate would certainly hurt exports and help imports. At the other pole, if the foreign exchange markets see the tariff as a negative action that undermined their confidence in the U.S. economy, then capital might flow out of the U.S. at a substantial pace. This would, of course, tend to lower the exchange rate and raise domestic interest rates. In this case we could expect, our net export position to do considerably better than indicated in table 1. But it is also likely that the wider economy would do worse, as interest sensitive activities feel the bite of of higher borrowing costs.

It is beyond the scope of this paper to speculate in any detailed way about the most probable path for interest rates and the exchange rate in response to a tariff. The behavior of these variables shown in table 1 are plausible, but other paths are equally plausible. Rather than produce a large array of simulations of alternative interest rate and exchange rate scenarios, it is probably most useful to merely demonstrate the sensitivity of the simulation results in table 1 to the behavior of interest rates and the exchange rate, particularly the latter.

Case 2: Table 2 presents the results of a second simulation like the first but with interest rates and the exchange rate constrained to baseline values. By constraining the exchange rate, we are, in effect, assuming there occurs an autonomous increase in the demand for net exports or decrease in the demand for dollar denominated assets. Again, this is not an assumption about what would likely happen but rather an analytical exercise to demonstrate how critical these variables are in determining the precise macroeconomic effects of a tariff. (Although it can not be determined from table 2, the dominant influence on the change in the results is the change in the exchange rate.) The salient points found there are:

- Real GNP7 falls below baseline in 1986 and 1987 more or less as it did in the first case, in 1988 the GNP loss has been reduced substantially and from 1989 on it is approximately back to base line. This makes it clear that the longer term effects of the tariff depend critically on how the exchange rate and interest rates move. If a substantially lower exchange rate were accompanied by a substantially higher level of interest rates, then this reduction of the loss of real output would not occur, and would be distributed differently, with more of the loss concentrated on the wider economy (i.e., interest sensitive consumption and investment expenditures) and less on the trade sector (i.e., exports).

- Inflation results in 1986 and 1987 are little changed by lower exchange rate and interest rates. In subsequent years, however, inflation falls less below baseline because of the presence of stronger aggregate demand.

- Net exports show a sustained improvement as compared to the first simulation. Real export volume stays, more or less, at the baseline values. Real imports fall, relatively, in the final three years of the time interval. As before net exports converge back towards the baseline but most of the burden of adjustment is placed on imports.

TABLE 2. The Macroeconomic Consequences of a Three-Year, 20 Percent, 15 Percent, and 10 Percent Declining Rate Ad-Valorem Tariff on All Imported Goods, With Interest Rates and the Exchange Rate Unchanged From Base Case

	1986	1987	1988	1989	1990	1991
Real GNP (billions of 1972 $)						
A	1731.2	1784.1	1852.9	1924.6	1986.7	2040.7
B	1739.3	1797.3	1858.5	1920.3	1980.4	2037.1
D	-8.1	-13.2	-5.6	4.3	6.3	3.6
%	-0.5	-0.7	0.3	0.2	0.3	0.2
Consumer Price Index (percent change)						
A	5.5	5.1	5.0	4.6	5.3	5.6
B	3.9	4.6	5.2	5.4	5.7	5.7
D	1.6	0.5	-0.2	-0.8	-0.3	-0.1
%	40.4	10.6	-2.9	-15.1	-6.1	-2.4
Exports (billions of $)						
A	425.8	488.6	551.1	611.8	681.3	764.2
B	416.6	471.0	529.8	594.2	669.0	755.2
D	9.2	17.6	21.3	17.6	12.2	9.1
%	2.2	3.7	4.0	3.0	1.8	1.2
Imports (billions of $)						
A	511.3	561.8	629.5	709.7	804	889.8
B	521.5	589.7	658.0	725.3	804	886.8
D	-10.2	-27.9	-28.5	-15.6	-0.4	3.0
%	-1.9	-4.7	-4.3	-2.1	-0.1	0.8
Net Exports (billions of $)						
A	-85.5	-73.2	-78.4	-97.9	-123.2	-125.5
B	-104.8	-118.7	-128.2	-131.1	-135.9	-131.6
D	19.4	45.5	49.7	33.2	12.6	6.1
%	-18.5	-38.4	-38.8	-25.3	-9.3	-4.6
Real Exports (billions of 1972 $)						
A	159.0	171.5	183.8	195.8	208.2	221.1
B	159.0	171.0	182.1	194.0	206.9	220.7
D	0.0	0.5	1.6	1.9	1.3	0.4
%	0.0	0.3	0.9	1.0	0.6	0.2

(continued)

Key: A = Economy with 20 - 15 - 10 percent tariff, interest and exchange rates unchanged.

B = Base Case
D = A - B
% = (A - B)/B times 100

TABLE 2. The Macroeconomic Consequences of a Three-Year, 20 Percent, 15 Percent, and 10 Percent Declining Rate Ad-Valorem Tariff on All Imported Goods, With Interest Rates and the Exchange Rate Unchanged From Base Case -- continued

	1986	1987	1988	1989	1990	1991
Real Imports (billions of 1972 $)						
A	178.2	179.2	188.0	200.8	215.6	225.1
B	183.0	193.6	202.4	209.7	217.6	225.4
D	-4.8	-14.4	-14.4	-8.9	-2.0	-0.3
%	-2.6	-7.4	-7.1	-4.3	-0.9	-0.1
Real Net Exports (billions of 1972 $)						
A	-19.2	-7.7	-4.2	-5.0	-7.4	-4.0
B	-24.0	-22.6	-20.3	-15.8	-10.7	-4.7
D	4.8	14.9	16.0	10.8	3.3	0.7
%	-20.0	-66.0	-79.1	-68.4	-30.8	-15.1
Federal Budget Deficit (billions of $)						
A	131.4	165.9	167.4	195.8	179.9	173.8
B	206.7	217.0	- 14.0	210.1	195.9	186.0
D	-72.3	-51.1	-46.6	-14.2	-16.1	-12.2
%	-36.4	-23.6	-21.8	-6.8	-8.2	-6.5
3-Month Treasury Bill Rate (percent)						
A	8.47	9.40	9.10	8.19	7.31	7.05
B	same					
D						
%						
Exchange Rate (1970 = 1)						
A	1.038	0.985	0.957	0.929	0.899	0.886
B	same					
D						
%						

Key: A = Economy with 20 - 15 - 10 percent tariff, interest and exchange rates unchanged.

B = Base Case
D = A - B
% = (A - B)/B times 100

- Revenue collected by the tariff is not substantially changed by these assumptions. Deficit reduction, however, is somewhat greater in 1988 because of other revenue inflows stemming from a relatively stronger economy.

The Question of Tariff Absorption by Foreign Exporters

The point has been raised by some analysts of the tariff issue that exporters to the U.S. market would be inclined to absorb (i.e., not pass through to consumers) a sizable portion of the tariff, that is, bear a larger burden of this "tax" than was true in the two previous simulations. The argument that a sizable degree of absorption would occur is based on the knowledge that the great appreciation of the dollar exchange rate in recent years has led (on average) to a sizable stretching of profit margins on exports sales to the U.S. In other words, by not cutting their prices in line with the dollar's appreciation, exporters have allowed the price of their goods in their own currency to rise with the strong dollar. Given that, it is argued that importers would be unlikely to defend those extra profits and risk a sizable loss of market share if faced with a temporary tariff levy. Rather, they would lower the dollar price of their product.

Whether such "absorption" would occur and to what degree it would occur is not judged in this report. It is worth noting, however, that the inclination to absorb would likely hinge in a substantial way on what importers generally expected the exchange rate to do. Absorption would be more likely if the dollar was expected to remain strong or appreciate. On the other hand, the expectation of a significantly weaker dollar would likely reduce the incentive to reduce prices, because a falling dollar exchange rate would be effectively reducing prices (in their own currency). Perhaps, where significant import price inelasticities exist, exporters to the U.S. market might actually raise prices to gain what extra profits are possible before the exchange rate falls, exacerbating the price and output effects of the tariff.

Case 3: To provide some notion of how absorption might affect the macroeconomic consequences of a tariff, a further optimistic assumption of 50 percent absorption of the tariff by importers is layered on the simulation reported in table 2 above. Again, this is not a forecast of what would happen, but another analytical exercise to determine the nature and sensitivity of the macroeconomic results to the absorption assumption. Accordingly, the price of goods exported to the U.S. are cut relative to the baseline, by approximately 10 percent in 1986, 7.5 percent in 1987, and 5 percent in 1988. The results of that simulation are presented in table 3. The important conclusions to be drawn from that are:

- Absorption of 50 percent of the tariff, if it occurred, would more or less cut in half the real output loss to the U.S. economy over the three years the tariff is in effect. Absorption leads to U.S. consumers paying less of the tax burden of the tariff and foreign exporters more of that burden. As compared to the results of no exporter absorption (p. 10, 11, 12, 13), the U.S. is better off, but the rest of the world is worse off.

- Absorption will significantly limit the rise of inflation associated with the tariff in the previous simulations. In this exercise the added rate of increase in the CPI caused by the tariff is cut in half.

- Net exports improve initially as the dollar value of imports is reduced by price cutting, however, this gain vanishes by 1989. Real imports are greatly helped by absorption, recovering nearly half of the volume lost if absorption were not undertaken.

- Revenue collection from the tariff would fall off about $5 billion in 1986 with absorption, as price cutting reduces the dollar value of imports; however, real import volume improves sufficiently in 1987 and 1988 to offset the effects of price cutting and keep tariff receipts about the same in those years as in the two previous simulations.

Raising a Tariff vs Raising Income Taxes: What Macroeconomic Difference Does it Make

It might be useful to consider how the tariffs macroeconomic impacts differ from raising the same amount of revenue with an income tax. Toward this end, a fourth simulation of the DRI model was done. In this case, the tax base of the personal income tax was broadened sufficiently to raise $75 billion, $60 billion, and $45 billion in the years 1986 through 1988 respectively. The results are presented in table 4, and suggest the following:

- With a like size income tax increase, real GNP is down more below baseline than was the case with a tariff (see table 1) from 1986 through 1988. In 1989 they have approximately the same depressing effect. In 1990 and 1991, however, the income tax has a far less depressing effect. The reason the income tax is more depressing, when it is in effect, is that imports absorb less of the depressing effects of the income tax than was true of the tariff. Keep in mind, however, that this is assuming no retaliation to the tariff. Retaliation sufficient to reduce U.S. real export volume 5 percent to 7 percent would likely lead to a cut in real activity to the same degree as the income tax increase during this 1986 to 1988 period. In subsequent years, the income tax is less depressing than the tariff because it does not lead to a large export depressing appreciation of the exchange rate.

- There is no upward push on the price level with an income tax. Quite the opposite occurs: The inflation rate would fall about 0.5 percentage points at peak effect.

- Net exports increase with an income tax, but the improvement is less than in the case of the tariff (without retaliation). Falling domestic income leads to a significant reduction of the flow of imports, down around 5 percent from 1988 to 1991. A rising exchange rate, however, works to bring down exports about 5 percent by 1991. Together, these two movements bring net exports approximately back at baseline by 1991. Thus, the mid term effect on the trade balance is actually better than with a tariff (see table 1), and, in terms of real net exports, the income tax is far less depressing than the tariff if you believe the exchange rate would rise as much as indicated in table 1.

- The Federal budget deficit falls less with the income tax, as a greater reduction in domestic economic activity leads to

TABLE 3. The Macroeconomic Consequences of a Three-Year, 20 Percent, 15 Percent, and 10 Percent Declining Rate Ad-Valorem Tariff on All Imported Goods With Interest Rates, and the Exchange Rate Unchanged, and With 50 Percent Absorption in the Price of Imports

	1986	1987	1988	1989	1990	1991
Real GNP (billions of 1972 $)						
A	1736.0	1789.1	1855.6	1924.0	1984.9	2039.2
B	1739.3	1797.3	1858.5	1920.3	1980.4	2037.1
D	-3.3	-8.2	-2.9	3.6	4.5	2.1
%	-0.2	-0.5	-0.2	0.2	0.2	0.1
Consumer Price Index (percent change)						
A	4.8	4.9	5.2	5.0	5.5	5.6
B	3.9	4.6	5.2	5.4	5.7	5.7
D	0.8	0.3	0.0	-0.4	-0.2	-0.1
%	21.4	6.2	-0.0	-7.7	-3.1	-1.6
Exports (billions of $)						
A	423.2	485.0	548.8	610.8	680.8	762.9
B	416.6	471.0	529.8	594.2	669.0	755.2
D	6.6	14.0	19.0	16.6	11.7	7.7
%	1.6	3.0	3.6	2.8	1.8	1.0
Imports (billions of $)						
A	485.7	553.5	626.5	718.5	805.0	889.0
B	521.5	589.7	658.0	725.3	804.9	886.8
D	-35.7	-36.2	-31.5	-6.8	0.1	2.3
%	-6.9	-6.1	-4.8	-0.9	0.0	0.3
Net Exports (billions of $)						
A	-62.5	68.5	-77.7	-107.7	-124.3	-126.1
B	-104.8	-118.7	-128.2	-131.1	-135.9	-131.6
D	42.3	50.2	50.5	23.4	11.6	5.5
%	-40.4	-42.2	-39.4	-17.9	-8.5	-4.2
Real Exports (billions of 1972 $)						
A	159.1	172.5	185.1	196.8	208.7	221.3
B	159.0	171.0	182.1	194.0	206.9	220.7
D	0.1	1.5	2.9	2.9	1.8	0.6
%	0.1	0.9	1.6	1.5	0.9	0.8

(continued)

Key: A = Economy with 20 - 15 - 10 percent tariff, with 50 percent absorption.

B = Base Case
D = A - B
% = (A - B)/B times 100

TABLE 3. The Macroeconomic Consequences of a Three-Year, 20 Percent, 15 Percent, and 10 Percent Declining Rate Ad-Valorem Tariff on 11 Imported Goods, With Interest Rates, and the Exchange Rate Unchanged, and With 50 Percent Absorption in the Price of Imports -- continued

	1986	1987	1988	1989	1990	1991
Real Imports (billions of 1972 $)						
A	180.4	186.2	198.9	203.9	215.9	224.9
B	188.0	193.6	202.4	209.7	217.6	225.4
D	-2.6	-7.8	-8.5	-5.9	-1.9	-0.5
%	-1.4	-3.8	-4.2	-2.8	-0.9	-0.2
Real Net Exports (billions of 1972 $)						
A	-21.3	-13.7	-8.8	-7.0	-7.0	-3.6
B	-24.0	-22.6	-20.3	-15.8	-10.7	-4.7
D	2.7	8.8	11.5	8.8	3.7	1.1
%	-11.2	39.2	-56.5	-55.5	-34.5	-24.0
Federal Budget Deficit (billions of $)						
A	133.0	159.6	168.7	196.1	181.4	175.1
B	206.7	218.0	214.0	210.1	195.9	186.0
D	-73.7	-57.4	-50.3	-13.9	-14.6	-10.8
%	39.1	26.5	28.5	6.6	7.4	5.8
3-Month Treasury Bill Rate (percent)						
A	8.47	9.40	9.10	8.19	7.31	7.05
B	same					
D						
%						
Exchange Rate (1970 = 1)						
A	1.038	0.985	0.957	0.929	0.899	0.886
B	same					
D						
%						

Key: A = Economy with 20 - 15 - 10 percent tariff, with 50 percent absorption.

B = Base Case

D = A - B

% = (A - B)/B times 100

TABLE 4. The Macroeconomic Consequences of a Three-Year Increase in Income Tax Revenues, Equal to $75 Billion, $60 Billion, and $45 Billion in 1986, 1987, and 1988

	1986	1987	1988	1989	1990	1991
Real GNP (billions of 1972 $)						
A	1718.6	1764.3	1825.1	1898.7	1966.6	2024.1
B	1739.3	1797.3	1858.5	1920.3	1980.4	2037.1
D	-20.7	-33.0	-33.4	-21.6	-13.9	-13.1
%	-1.2	-1.8	-1.8	-1.1	-0.7	-0.6
Consumer Price Index (percent change)						
A	3.8	4.3	4.7	4.9	5.2	5.3
B	3.9	4.6	5.2	5.4	5.7	5.7
D	-0.1	-0.4	-0.5	-0.5	-0.4	-0.4
%	-2.9	-7.4	-9.1	-9.1	-7.4	-6.8
Exports (billions of $)						
A	415.9	464.4	515.3	570.7	637.8	715.7
B	416.6	471.0	529.8	594.2	669.0	755.2
D	-0.8	-6.6	-14.5	-23.5	-31.2	-39.5
%	-0.2	-1.4	-2.7	-3.9	4.7	-5.2
Imports (billions of $)						
A	512.9	568.1	625.8	688.0	764.6	841.9
B	521.5	589.7	658.0	725.3	804.9	886.8
D	-8.6	-21.6	-32.2	-37.3	-40.3	-44.9
%	-1.6	-3.7	-4.9	-5.1	-5.0	-5.1
Net Exports (billions of $)						
A	-97.1	-103.7	-110.5	-117.2	-126.8	-126.2
B	-104.8	-118.7	-128.2	-131.1	-135.9	-131.6
D	7.8	15.0	17.6	13.9	9.1	5.4
%	-7.4	-12.6	-13.7	-10.6	-6.7	-4.1
Real Exports (billions of 1972 $)						
A	158.9	170.3	180.6	191.5	203.6	216.8
B	159.0	171.0	182.1	194.0	206.9	220.7
D	-0.1	-0.7	-1.5	-2.4	-3.2	-3.8
%	0.0	-0.4	-0.8	-1.3	-1.6	-1.7

(continued)

Key: A = Economy with income tax increase
B = Base Case
D = A - B
% = (A - B)/B times 100

TABLE 4. The Macroeconomic Consequences of a Three-Year Increase in Income Tax Revenues, Equal to $75 Billion, $60 Billion, and $45 Billion in 1986, 1987, and 1988 — continued

	1986	1987	1988	1989	1990	1991
Real Imports (billions of 1972 $)						
A	180.9	189.3	198.3	207.8	218.2	227.3
B	183.0	198.6	202.4	209.7	217.6	225.4
D	-2.1	-4.3	-4.1	-2.0	0.6	1.9
%	-1.2	-2.2	-2.0	-0.9	0.3	0.8
Real Net Exports (billions of 1972 $)						
A	-22.0	-19.0	-17.7	-16.3	-14.6	-10.4
B	-24.0	-22.6	-20.3	-15.8	-10.7	-4.7
D	2.1	3.6	2.6	-0.5	-3.8	-5.7
%	-8.5	-15.9	-12.8	3.1	35.8	121.1
Federal Budget Deficit (billions of $)						
A	141.8	172.4	179.6	225.1	202.5	190.4
B	206.7	217.0	214.0	210.1	195.9	186.0
D	-64.9	-44.6	-34.4	15.0	6.6	4.4
%	-31.4	-20.6	-16.1	7.1	3.4	2.4
3-Month Treasury Bill Rate (percent)						
A	8.08	9.26	8.97	8.20	7.05	6.70
B	8.47	9.40	9.10	8.20	7.31	7.05
D	-0.39	-0.14	-0.13	0.0	-0.26	-0.35
%	-4.6	-1.5	-1.5	0.0	-3.5	-5.0
Exchange Rate (1970 = 1)						
A	1.037	0.992	0.976	0.960	0.936	0.923
B	1.037	0.985	0.957	0.929	0.899	0.806
D	0.0	0.007	0.019	0.031	0.037	0.037
%	0.0	0.7	2.0	3.3	4.1	4.2

Key: A = Economy with income tax increase
B = Base Case
D = A - B
% = (A - B)/B times 100

> greater reductions of other tax revenues. Of course, if retaliation occurs on the scale suggested above, there would be little difference in the deficit reduction capability of an income tax or a tariff.

A caveat: This has been a comparison of the macro-economic effects of these two forms of taxation. At the microeconomic level, the public finance literature is likely to draw further distinctions between the efficiency and equity consequences of a tariff and an income tax.

Sensitivity of the Revenue Estimates

The revenue collected by the tariff did not vary to any substantial degree across the three simulation exercises (see tables 1, 2, 3), raising between $70 to $75 billion in the first year, and a nearly constant $60 billion and $45 billion in the next two years. The revenue raised depends, of course, on the current dollar value of imports and that depends on the overall price and income responsiveness (elasticities) of import demand. These elasticities determine how much the value of imports change in response to the change in relative prices and incomes caused by the tariff.

The elasticity estimates in the DRI model are within the range of credible outcomes (for merchandise imports the average elasticity with respect to relative price ranges from -0.3 in the short-run to -0.8 in the long-run.), but they are estimates nevertheless, and susceptible to some error. In light of this, it is probably prudent to think of the revenue estimates presented in this report as lying within a range of nearly as probable outcomes. In table 1, for example, a moderately more elastic response to the higher price and lower income consequences of the tariff could easily reduce the revenue estimate for 1986 by $10 billion dollars and, if import demand response is at the upper extreme of known elasticity estimates, tariff revenue might fall another $10 billion.

This type of analysis is equally valid in the direction of more inelasticity, that is, more revenue would be collected because the dollar value of imports does not fall as much in response to the tariff, thus the 20 percent levy is applied to a bigger base.

Again, if one took plausible extreme values, perhaps another $15 to $20 billion in revenue might be collected by the tariff. Now, it not reasonable to assign an equal probability of outcome to these extreme estimates but is reasonable to think of the estimates of revenue from the tariff as falling "in the neighborhood of" $75 billion, $60 billion and $45 billion, in three years respectively, where this "neighborhood" might stretch plus or minus 15 percent.

Conclusion

A tariff on imports is a tax that will likely be borne to considerable degree by the American economy. The results presented in table 1, which assume no foreign retaliation and no active monetary policy response, show outcomes that are broadly consistent with standard macroeconomic theory. That is, a tariff reduces real output, as the favorable effect of heightened sales, profits and employment for domestic production competing with imports is outweighed by the depressing effect of lower real income economy wide, and only temporarily improves the balance of trade. The temporary nature of the foreign trade benefits stems, in part, from the fact that a tariff on imports by reducing import sales also reduces the supply of dollars offered in foreign exchange markets and leads to a rise (above baseline) in the value of the dollar. This, of course, works to offset initial improvement in the trade balance by reducing exports and offsetting the tariff's dampening effect on imports. These results also suggest that the tariff would nevertheless collect a substantial amount of revenue, and, in turn, achieve a substantial amount of reduction in the budget deficit over the period it is in effect.

Two subsequent simulations were undertaken to demonstrate the sensitivity of the results in table 1 to the behavior of interest rates, the exchange rate, and the degree of absorption of the tariff by foreign exporters to the U.S. market. If one can make the more optimistic assumption that interest rates and the exchange rate do not rise to the degree observed in table 1, then the longer-run, depressing effect of the tariff on real GNP that occur through lower real exports can be reduced. It is important, however, that one be sensitive to why the exchange rate would not rise to the degree noted in table 1. A more stimulative monetary policy might be able to effectively peg the exchange rate at a lower level, but one must be sensitive to inflation effects and how these might affect the domestic economy and the trade sector. The international capital market might, as a result of the tariff, lose some confidence in the U.S. economy and start a capital outflow. That would work to bring the exchange rate lower, but it would also likely push domestic interest rates higher. Thus, while the trade balance might improve, the interest sensitive sectors of the domestic economy would decline. It probably cannot be stressed enough that the longer term consequences of this type of policy will hinge critically on what one thinks the exchange rate might do in response to a temporary imposition of a tariff on imported goods.

The third simulation applies one more layer of optimism onto the simulation exercise by assuming approximately 50 percent of the tariff is absorbed by exporters to the U.S. through price reduction on their goods in their own currencies. Absorption, if it occurred to a substantial degree, limits both the near term inflation, and output reducing effects of the tariff. Substantial absorption would mean that foreign profits bear a great part of the burden of the tariff, in effect, insulating the U.S. economy from its effects. Since absorption reduces the fall of import volume, the country would, in comparision to the case without absorption, have more imported goods to choose from, and for the economy, of course, the terms of trade have improved.

Absorption, particularly if coupled with no appreciation of the exchange rate, might seem to make a tariff on imports a tempting policy. Yet it seems prudent to consider well how probable are the conditions necessary to translate the outcomes of table 1 to the far less negative effects of table 3. Further, despite the possible macroeconomic temptation of a tariff _if_ little exchange rate appreciation and _if_ a lot of absorption occurs, a tariff is a tax that is a very distorting levy, deviating widely from what is usually considered to be an efficient and equitable tax.

Some will argue that the great size of our "twin deficits" have brought us to a situation where "desperate times call for desperate action." Opponents respond, that the times might not appear so desperate if some less desperate action were first taken; that is, could not our budget deficit and balance of payments problems be improved, and improved with less distortion and risk, with conventional monetary and fiscal policies?

Nevertheless, there are those who might look at the results in table 3, or those of some analysis with similar outcomes, and confident about the conditions needed to get those results, see this not as a desperate act but as a quite direct, logical and promising one: a way of taxing foreign profits and further augmenting the flow of world savings into the U.S. economy. Critics would ask: Should a highly advanced industrial economy, in a world filled with capital-starved, less developed countries, be trying to takein still more of world savings?

It is likely that savings is the key to understanding the "twin deficit" problem. An economy such as ours which has a low savings rate relative to its domestic investment, in part because of large Federal deficits (i.e., Federal dis-saving), in a world where, on average, our trading partners have a relatively high savings rate relative to their rate of domestic investment, in part because there may be less government dis-saving, can be expected to experience an inflow of foreign capital (savings), a rise in its exchange rate, and in turn, a large trade deficit to go along with the budget deficit. In the longrun, if the U.S. wants to reduce the trade deficit, it must either reduce its rate of domestic investment or increase its rate of savings. Reducing the budget deficit (reducing government dis-savings) is a way of increasing our national rate of saving. In the long-run, economic analysis is clear: reducing the budget deficit is the straightest route to substantially and permanently reducing the trade deficit.

A tariff on imports is certainly a way of reducing the budget deficit, increasing our rate of savings, and, at least initially, reduce the trade deficit. But, in a system of flexible exchange rates it is unlikely that the trade balance will be permanently improved, and there is substantial risk that the volume of U.S. exports might deteriorate. Thus, a tariff offers no "quick fix" to the trade deficit beyond its ability to raise domestic savings but does pose some risks for U.S. exports. Therefore, the question is really reduced to: Is a tariff the best type of tax to raise revenue for deficit reduction?

ps/agf/rw

The **Chairman**. Dr. Klein, how would you distinguish the effects of an import surcharge as opposed to a tax increase of the same magnitude, a domestic tax of the same magnitude?

Dr. **Klein**. I would go along with the domestic tax of the same magnitude. But, of course, an economist would probably want to see taxes that didn't disturb the price system, the market signal. An import surcharge disturbs that because it focuses on a particular batch of goods. A general tax that is neutral as far as its market effect is concerned would, in my opinion, be better.

The **Chairman**. Well, highlight again, then, what you think are the down sides of the import surcharge.

Dr. **Klein**. Well, I have given two scenarios as regards interest—dollar rates and interest rates—and chosen one. But my attitude would be we don't know—and I say this with all scientific fervor. The economic profession really doesn't know and no other profession knows exactly what will happen to rates.

If you have that degree of uncertainty and if you rate the possibility of crash landing as 10 percent—20 percent—then you shouldn't take that risk. You should factor that risk into your considerations and it would be very unwise to bear the risk of a crash landing.

The **Chairman**. If the countries that have been exporting to us have been the beneficiaries of our very high dollar—and I'm not here going to get into what I regard as their unfair trade practices—but if they had been the beneficiary, why shouldn't they bear part of the burden through an import surcharge?

Dr. **Klein**. Why shouldn't they?

The **Chairman**. Why shouldn't they?

Dr. **Klein**. I think it's a question of whether two wrongs make a right. We are looking for free trade practices around the world. It has been the policy of the United States since the postwar era—the end of the Second World War—to be in favor of multilateral free trade. That's a principle. And we have benefited by it. There has been an enormous expansion to the 1950's, 1960's and we should try to recapture that rather than to introduce divisive measures.

The **Chairman**. Mr. Elwell, in your models explain what you presumed about capital flows under different variables. I know some of your assumptions are debatable and I want to highlight them.

Mr. **Elwell**. Well, in the larger report we make it very clear that the exchange rate is a critical question. It is made critical and very uncertain because capital markets have the potential to play a major role in determining what that exchange rate does. The DRI model is not equipped to handle international capital flows in any director detailed way. It will, however, allow the exchange rate to respond to interest rate differential as induced by the policy change.

When you think about this type of policy—and this is what was pointed out in the report—I think you have to think long and hard about what the risks are in a capital market response to a tariff on imports. They could be very negative.

The **Chairman**. All right. Last question. If I read your model correctly, you are not presuming a decline in interest rates and the value of the dollar even if we cut the budget. Or narrowing the deficit, I should say.

Mr. ELWELL. Yes; in part, that's because it is a temporary measure whose impact vanishes very fast.

The CHAIRMAN. What's a temporary measure?

Mr. ELWELL. In this study, the deficit reduction effects are temporary. They are gone after 3 years. They are outweighed by the effect on the trade flows and the exchange rate.

The CHAIRMAN. Well, not if we make permanent cuts in some programs they are not gone after 3 years. The programs are gone. But in any event, even during the 3 years—assuming at the end of it we go back to where we were, you are not presuming much during the 3 years. Is that because it is just temporary and that's your assumption?

Mr. ELWELL. In the early years, what seems to be going on is the tariff itself is a substantial nominal shock to the economy and that has the initial effect of pushing up interest rates at least in nominal terms. And that is not a stimulus to economic activity at all.

Again, alternative interest rate scenarios, not so much in the near term but longer term, I think, may be more of an issue.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Elwell, I don't want to be critical of a body on which we depend so much and from which we receive so much, but in your model I hear you talk about the effects on exports. I mean a decline in exports as a consequence of a surcharge. But did you model the plan whereby we keep the wheat and export the farmers?

Mr. ELWELL. It wouldn't fit in the machine actually. [Laughter.]

Senator MOYNIHAN. All right. Not there. Another request for appropriations. [Laughter.]

Let me just make the point that these are a devastating set of outcomes. And they are not sure. I mean we ask the machine and the machine answers. Well, it's a form of Delphic oracle of some kind, but that is not very sure at all.

You see that tariff raising $180 billion in 3 years.

Mr. ELWELL. In the cumulative scheme?

Senator MOYNIHAN. Yes.

Mr. ELWELL. If you accept the sensitivities in that model, yes that's the projected cumulative revenue collection.

Senator MOYNIHAN. This Government has $240 billion worth of loan assets. I mean all kinds of loans. Whether we had a deficit or not, you can make a very good case for simply selling that commercial paper into the normal secondary mortgage market. The CBO thinks, we could pick up about $140 billion. Just sell our loans that we have got. For example, General Electric owes the Export-Import Bank. A fairly good commercial paper. And then not go through this.

I would like to thank Dr. Klein and thank Mr. Elwell for a very nice piece of work.

Dr. Klein, I know that a Nobel laureate is careful not to get into very nonscientific areas, but I thought I heard you say that with respect to the confidence in the American economic system, which is presumably one of the reasons capital flows here and we have the current arrangement, that a measure like this, a statement of, you know, we can't live with the world, we are going to put a 20-percent surcharge on, or whatever, is a statement that we are kind of getting out of the arrangements that we put in place just after World War II when we had confidence of what would come of an open system. We have lost that confidence ourselves. And that this, in turn, would have the effect on the confidence other people have in us.

I know you can't model that, but you can still—it seems to me that you raised that.

Dr. KLEIN. Well, there is an enormous respect for the performance of the American economy throughout the world and capital has flowed or the net has been an inflow. Our outflow has been reduced, and the inflow for a few years has been increased.

Part of this is because we are viewed as a safe haven, a very significant one. And part of it is based on rather good investment opportunities in America. But that confidence has been brought under some stress. The Continental Illinois failure was one shaking of confidence, and other bank problems haven't done anything to improve the confidence. I believe that is a suspicion that is held throughout the world.

There aren't too many alternatives, but there is a worry about the adequacy of accounting, and, indeed, of the asset position of the American financial system. We are looking for the possibility of some kind of trigger effect. The announcement of these very drastic import surcharges would be a trigger effect.

Senator MOYNIHAN. A trigger effect.

Dr. KLEIN. I think the confidence issue goes much more into the whole structure of the American financial system and questioning whether we are running a good shop with $200 billion budget deficits. Those are the ones that could be shaken.

Senator MOYNIHAN. And in that context, this could trigger a response.

Dr. KLEIN. One should take that into account.

Senator MOYNIHAN. And I heard you say, sir, that if the chances were 10 or 20 or 30 percent——

Dr. KLEIN. That's a subjective guess.

Senator MOYNIHAN. Sure. At such levels, no prudent committee would take that risk with this economy.

Dr. KLEIN. That's my point of view. That it would be imprudent.

Senator MOYNIHAN. Thank you very much, sir.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Mr. Chairman, these hearings this morning are a good idea, but the more I listen to the testimony about the surcharge, the more I think it's a bad idea.

The CHAIRMAN. You think it's a what?

Senator Baucus. The surcharge is a bad idea. It's a good idea to hold the hearings to reveal a bad idea.

It's clear that a surcharge doesn't make sense. I think it's good that we have these hearings to discuss the problems a surcharge would create. First, there is no doubt in my mind that other countries would retaliate in one way or another. It might not be via a surcharge, but it would be something. We know that.

And, second, these analyses and these models show that a surcharge isn't anything like the panacea some of its proponents would like to think it is. The surcharge looks to me like an attempt to blame other countries for our lack of discipline or to put the burden of the solution on to some other country. If we don't want to solve our problems here at home or we don't understand our problems enough, we seek to assign blame elsewhere, and put the burden elsewhere.

I think that this has been a good discussion this morning; it has helped to reveal some problems. But I think it would be unwise for us to spend much more time on this; we should put this idea to bed pretty quickly and go on to other matters. Thank you.

The CHAIRMAN. I expect we will go on to—I don't want to say other—but additional matters before very long.

Senator Heinz.

Senator HEINZ. Thank you very much, Mr. Chairman.

Dr. Klein, good to see you again. We always welcome distinguished Pennsylvanians to the committee and to Washington. You must be feeling like you are spending more time here than in Philadelphia, but we welcome you nonetheless.

Dr. Klein, yesterday Mr. Roosa and others suggested that one way of coping with the principal topic of this hearing; namely, exchange rates, would be to have the principal players, the EC, the United States, Japan or the G-5, if you will, discuss among themselves what would seem to be reasonable relationships, and then through appropriate intervention attempt to bring those about.

Two questions. First, is that the best option? And whether it is or not, would it be effective in achieving the goal?

Dr. KLEIN. Well, I'm a fan of coordinated policy. And I think there is a policy mix that could be coordinated among the G-5 that would make the world in much better shape economically. But I think that intervention alone on the foreign exchange markets is probably not going to be the effective way to bring the dollar down. There must be a much more comprehensive policy of coordination dealing with fiscal and monetary policies as well. Rudy Penner stated something that is very important, that the amount of capital privately held throughout the world can move about very quickly. I think that was fundamental in bringing down Bretton Woods. And it's a fundamental problem in the face of reconstituting a fixed rate system—that there is a tremendous amount of discretionary capital that can move about on short notice, and undo the fixed rules that are set up. And for that reason, I think, the central banks alone cannot intervene to fix rates. And if you say that we don't want to do it through running the printing presses—we put that restraint out—then they just don't have the——

Senator HEINZ. What's the alternative then? How do we deal with those enormous capital flows that seem to have dwarfed the system?

Dr. KLEIN. Well, I think the alternatives are fairly clear—not easy to execute—but the first alternative for the United States is to have a twist between fiscal and monetary policy, a tighter fiscal and an accommodating monetary policy, and to coordinate that with similar policies in other countries. It would not always be the same twist, but one to get some fiscal—domestic fiscal—stimulus in a number of the other countries in the G-5 to go along with this shift in fundamentals in America.

Senator HEINZ. So we should get them to reflate and that will——

Dr. KLEIN. Some. Those that are in a position——

Senator HEINZ. That will help our trade balance. I'm not quite sure how I see that if one believes that the dollar is artificially high. How that will necessarily help lower the dollar.

Dr. KLEIN. The dollar is artificially high as a weighted combination of several factors. What I'm suggesting is that we lessen the positive contribution of as many of those factors as we can; namely, interest rates and the American trade balance.

Interest rates would move first. That would—given other things determining where they are—that would help to bring the dollar down, and a commitment by the other countries to enter a coordinated scheme and the following through on that commitment would improve our trade position. That would be a second factor helping to bring the dollar down.

Senator HEINZ. Senator Packwood asked you on a related subject how you felt about a tax increase versus a surcharge. You said you would rather raise revenues by a tax increase.

There are a variety of ways we can tax. We can tax income. We can tax investments. We can tax consumption. This is really a lead up to my question. Do you have a particular preference there?

Dr. KLEIN. Well, I think I——

Senator HEINZ. Or are you of the little bit of everything school?

Dr. KLEIN. Mainly, I want to see the deficit brought down through a combination of tax increases and expenditure cuts. I would accept Senator Bradley's proposals on tax reform.

It's aimed mainly at achieving fairness in the tax system, but should be calibrated so as to bring in more revenue.

Senator HEINZ. If my colleagues would bear with me, I was leading right into the tax reform issue because it seems to me that one of the potential problems with all of these tax reform proposals is that, as they have been structured to date, they tend to tilt a tax system that is now already rather heavily tilted toward consumption still more toward consumption. At least that is what I have seen the various permutations of the numbers since all these proposals do require, for political and other reasons, a lowering of the rates; particularly, individual rates in order to make them attractive, viable, fair.

Is it possible in your judgment to design a tax reform approach without also neutralizing those consumption encouragement effects with some kind of consumption tax?

Dr. KLEIN. Yes, it is possible.

Senator HEINZ. And have it fast?

Dr. KLEIN. A consumption tax is very attractive from a point of view of economic analysis. But I think it's difficult to implement.

I think it's difficult to determine typical citizens' expenditures relative to determining typical citizens' income. That's a very technical issue. But I think that would be my main criticism of that.

Senator HEINZ. I'm not going to ask you a question, because my time is up, but I wouldn't want you to think that I was in favor of shifting toward a consumption-based tax system. I was asking the question on a consumption tax, which is value added, sales, so on and so forth. And you may want to come back to that some other time.

Thank you, Mr. Chairman.

The **Chairman**. Senator Long.

Senator **Long**. Dr. Klein, Paul Douglas used to serve on this committee and he had credentials as an economist. He was at one time the President of the American Economic Association. And he used to say to me that when you study economics, your first year in college, they usually would teach you about all you are going to learn about how the system is supposed to work. Then he said, from that time forward until you finish your Ph.D. degree, all the rest of an economist's education is teaching why it doesn't work that way. There is always some fellow who has got his thumb on the scale or who is short circuiting things or stealing or not playing by the rules of the game. With cartels and state trading and even downright robbery when you add all that up, you would come out with a different result than the one you anticipated. It gets very complicated, trying to deal with all that.

Do you know whether the Eurodollar market was a creation of the Soviet Union?

Dr. **Klein**. That's not accepted opinion.

Senator **Long**. Pardon?

Dr. **Klein**. That's not accepted opinion.

Senator **Long**. Well, a witness testified before this committee at one time—and nobody contradicted him at the time—that the Soviet Union found it to their advantage to create a market for American dollars in Europe because apparently they needed them and that's how they could get them. Have you ever heard anything or know anything about that, Mr. Elwell?

Mr. **Elwell**. No; I don't, sir.

Senator **Long**. Can you tell me anything more about that, Dr. Klein, as to whether the Soviet Union had anything to do with it?

Dr. **Klein**. I doubt it. I think the argument would be that we flooded the world with dollars in rebuilding Europe and other parts of the world after World War II, and again in pursuing our own battles in Vietnam. Flooding the world with dollars gave rise to the Eurodollars market, and the Soviet Union probably had some role, a very indirect role, in making it necessary for us to do something.

Senator **Long**. Now, I have not heard the latest figure. Can you tell me right now how many Eurodollars there are around the world. Obviously, we are including the Japanese. And there may be other dollars that are called "Eurodollars," too. Can you give me some idea as to how many Eurodollars there are outside the United States today?

Dr. **Klein**. That's one of the numbers I don't carry around in my head.

Senator **Long**. Can you, Mr. Elwell? I mean it's a lot of money.

Mr. **Elwell**. No, sir.

Senator **Long**. With your credentials, you ought to be able to come up within $200 or $300 billion of it. [Laughter.]

Dr. **Klein**. I could probably do that, yes.

Senator **Long**. Could you give me a guess? I won't hold you to it. You can correct it for the record.

Dr. **Klein**. Let's put it in the neighborhood of $1 trillion.

Senator **Long**. $1 trillion.

What's your guess, Mr. Elwell?

Mr. **Elwell**. I'm going to defer to my esteemed colleague.

Senator **Long**. Now it seems to me that we are constantly confronted with a situation where people keep bringing us problems, but we find a reason why their suggestions won't work. Oftentimes they don't have any answers that look like they are going to solve the problem for us. And I regret to say that even with the suggestions you have made here, I don't see how that's going to achieve much.

Mr. Roosa was up here testifying yesterday. Now he has a background in economics from Harvard and I recall the days when he was in the Treasury and they had some concrete suggestions. He indicated he wasn't going to recommend some of those they recommended back in those days. But it looked to me as though the things we had done then were working just a lot better than anything we are doing now. What we are doing now is nothing.

I gain the impression that what we are doing right now is just like floating on a raft down the Niagara River waiting to see what's going to happen. [Laughter.]

And when I pose the question how long can we keep this up, I'm not talking about the Federal deficit, but the trade deficit. How long can we keep this up?

Well, the answer is that we shouldn't want to find out. Something drastic and something very bad has to happen sooner or later.

Now here we are in a world where people want to treat this problem as though we are dealing with a world of free trade. That's a jungle out there. You have some nations and socialist nations with state trading. We are dealing with cartels. We are confronted with all kinds of cheating.

Do you think that these so-called voluntary import quotas is anything but cheating on the rules? I see you are nodding yes. I think you agree with that.

Dr. **Klein**. I agree.

Senator **Long**. Mrs. Thatcher was over here talking about some of these problems. And she would ask: How would you handle this problem? Well, I would think voluntary quotas would be the way to handle it. Well, it looks to me like voluntary quotas is just cheating. That's all. It's just pretending that that foreign country is voluntarily limiting those imports. I think I know about voluntary quotas. That means, "You either do this or else." You either do this or something very bad is going to happen, and you give them some idea as to what is going to happen.

But I don't see how we can sit here and pretend that we are going to let the market decide what happens when there are so many nonmarket forces in position to operate on that market. You have got an $80 billion drug trade in this Nation alone. What are they doing with all that money? I don't know. I don't believe anybody else does. But they are in a position to play a part in our trade problems. The socialist countries, the Soviet Union, OPEC all play a part in our trade problems. I do not see how we can responsibly look after the interests of this country when we see these enormous deficits playing a part in the deindustrializing America, and we just sit here talking about balancing the budget.

Do you want my prediction about balancing the budget? I'm not an economist. But it is not going to work. By the time we get through with all this, we will wind up in a recession and the deficit will be bigger than ever so I can't see answers other than maybe some of those that Mr. Roosa told us yesterday. I wish I could. If you have some other suggestions, I would like to have them.

Dr. KLEIN. Well, we won't balance the budget but we ought to move toward better balance. We won't get quite absolute free trade, but we ought to move in that direction. And when the world moved from bilateralism and commodity agreements—after World War II—as we moved more and more toward liberalization, the volume of trade increased dramatically and the world was better off.

So that's the direction in which we should go.

Senator LONG. Could I just ask one further question, Mr. Chairman?

The CHAIRMAN. One more.

Senator LONG. I've heard people who have some credentials as economists suggest that other countries are doing us a favor no matter how they cheat on the rules as long as they sell something cheaper than we can sell it for in this country. Do you agree with that philosophy?

Dr. KLEIN. That's a strict economic calculus. It's better to buy cheap than to buy dear. It's held down our prices in the last 3 or 4 years. The high dollar has contributed very significantly to winding down of inflation.

Senator LONG. Well, just to give you an example of that now. Here are the Saudis selling petroleum products below the price they would sell the oil for on the world market. At least that's what the oil people tell me. Here are the Mexicans shipping their ammonia and they will be shipping other chemicals in here. As much as 85 percent of the cost of that ammonia is the natural gas that goes into it. And the Mexicans will price the natural gas at zero if need be in order to get this market.

Do you think they are doing us any favors to put us out of business doing that type of thing to us—our refiners, our chemical plants?

Dr. KLEIN. Well, if it's predatory pricing in order to lock us in and then turn around and charge a higher price later, then it's to our disadvantage in the long run.

Senator LONG. Thank you.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

Dr. Klein, as always, I welcomed your testimony. I think it is critical for the committee. And a couple of things you said intrigued me and I think it's important that we follow up.

You said if we enacted an import surcharge that, in determining the effects of an import surcharge on the economy, we should factor in the risk of a crash landing. Could you describe for the committee—and you said whatever the risk, 10 percent even, much less 20 or 30 percent, in your opinion it was too great a risk to take. Could you describe for the committee what would be the economic impact of a crash landing?

Dr. KLEIN. Well, when we looked at this menu of scenarios with surcharge combinations, I was struck always by the fact that the depressing effects didn't last forever and that it was temporary.

You can see that on some of the bar charts that I have distributed. Eventually, in 2 or 3 years, one gets back to the baseline position. But when we put in the case of dollar down, interest rates up, this has a trigger effect of loss of confidence, that generated a true recession that is persistent.

And that's exactly what we want to avoid. We look at the world economy and say, well, we've had cycles up and down and they have been moderate, but we have now pushed the system to such large imbalances—the budget imbalance, the current account imbalance—that we keep worrying, are we going to wake up as professional forecasters and economists to the devastating headline the next morning that something really big has burst and become unravelled. And that's the thing that we want to avoid.

Senator BRADLEY. So that essentially you are saying that our margin for error is much, much less, given the effects of fiscal policy in this country in the last 4 or 5 years?

Dr. KLEIN. That's right.

Senator BRADLEY. There is another school of thought that would even take your analysis further and say that things are totally out of control; that we can't rein in these excesses in time to prevent the system from exploding. Now do you hold that view?

Dr. KLEIN. No; I think until something is done—the domestic budget deficit remains out of control, but I think that the current account will turn around rather significantly. If you look at the history of the American current account in this century, you will see that it fluctuates a good deal about zero. And the only times that it has been significantly out of balance were during World War I, and World War II—there were two large surpluses—and then at the present time this is an enormous deficit. And this is a fluctuating thing. It moves rather fast and, with 1 or 2 years time delay, a very significant turnaround in the dollar can eliminate that deficit.

Senator BRADLEY. What probability do you put to a reflation as a way to deal with the deficit?

Dr. KLEIN. Reflation within the United States?

Senator BRADLEY. Increased inflation, yes.

Dr. KLEIN. I think that would be a poor way to deal with it.

Senator BRADLEY. No; I don't mean as setting out as policy to do it. But absent fundamental action on any of these other areas that various witnesses have come before the committee to recommend, what is the probability that sooner or later, in the absence of that action, you are going to wake up to the morning headline? Isn't reflation at that point, the only way you save the system: through printing money?

Dr. KLEIN. Yes; I think the problem with inflation is that you lose control of its dynamics. And you would have to do exactly what you suggest.

Inflation can always be compensated by some indexing form on paper, but, in practice, it leads to dynamic situations that can be very harmful.

Senator BRADLEY. I'd like to ask just one more question, if I could.

What do you see as the economic problems and the economic impediments to growth in attempting to manage our international economic relations on a bilateral basis? Managing trade, structuring a deal with this country and that country as opposed to trying to reinvigorate the multilateral system.

Dr. KLEIN. Well, I think the bilateral system is very inefficient. And I think if you read the history of the transition from the bilateralism that was the outgrowth of World War II and the shift toward multilateralism, you will see that the shift accompanied a very great economic expansion in the world.

Senator BRADLEY. Thank you.

The CHAIRMAN. Gentlemen, thank you.

Now can we take Dr. Rudiger Dornbusch, from MIT.

Good morning, Doctor. And you have been very patient also, and we appreciate it. Why don't you go right ahead.

STATEMENT OF DR. RUDIGER DORNBUSCH, PROFESSOR, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Dr. DORNBUSCH. Mr. Chairman, I welcome the opportunity to present my views on the strong dollar and floating exchange rate. I want to briefly in my oral statement review three points that I have written on more extensively in the prepared statement.

The first is what the strong dollar has done for us. The second, whether our current account imbalance and the strong dollar present an aberration or what we should expect. And the third, what policies would get us out of the present difficulties.

The strong dollar has been extremely helpful for us in getting disinflation. Normally at this stage in the recovery, inflation would be well on its way to be above the average of the preceding recovery. We have extremely low inflation. And the small rise in import prices, the reduced rights and equal rights inflation are very significant factors in that.

But the second point is the strong dollar has hurt us very significantly in manufacturing. If we look at competitiveness of U.S. firms in any industry, export prices are by 30 to 40 percent higher than import prices of comparable commodities. The same is true with data available comparing import prices with domestic prices. That loss of competitiveness in manufacturing is reflected in the fact that today manufacturing employment is less than it was in the late 1970's.

That process is underway. There are lags in the adjustment of trade flows to a loss in competitiveness. We can expect at the current exchange rates even a worsening of that trend.

The second point I want to make is whether the high dollar is an aberration, a bubble, or whether it should be expected.

My argument is that with the fiscal policies we have been pursuing and the opposite fiscal policies having been pursued by major trading partners, and particularly Germany, Japan, and the United Kingdom, and our monetary policy being relatively tight compared to theirs, we can't be surprised that the dollar is where it is. Exactly what theory predicts. The theory was invented in the 1960's to explain what happened in Canada when fiscal policy was extremely expansionary and monetary policy very tight and we have an exact reenactment of that. So to economic theory, the strong dollar is not a surprise.

If I can direct your attention to table 4 on page 9 in my prepared statement. I show the extent of the divergence in fiscal policy here and abroad. We always look at our deficits and we see a big shift toward deficits. Abroad, exactly the same size of shift has occurred toward surpluses. So between the two areas, we really have now an 8 percent differential. That's the biggest differential peacetime, I believe, in the last 200 years.

So we mustn't be surprised that the dollar wants to show its reaction.

The third set of questions I want to address is remedies. And, first, intervention. Would it be a good idea to try and unhook the dollar by sterilized intervention. I say "sterilized intervention" because I assume that nobody would want to indulge in expansionary monetary policy, given our fiscal policy, simply to inflate the dollar down.

As to sterilized intervention, a lot of research at the Federal Reserve has shown that it does exactly nothing. We haven't really tried to use that as a remedy because we will be wasting time, important time, that we need now to set things straight.

I'll say the same thing much more strongly of international negotiations about target zones. Target zones for exchange rates, in the absence of active instruments to implement them, are absolute nonsense.

If we agree on target zones, the only way we can do that is by having target zones for real interest rates and for the budget. Without that, they don't make sense.

Import surcharges. I follow the arguments that Professor Klein and Rudy Penner brought. They are really an awful idea and I would differ with them to believe that the dollar is more likely to go up and I would add that 3 years from now when they come off, we have even worse problems than we have now.

That leaves capital control as the only respectable alternative. I think there's a very strong argument for capital controls. The dollar is high because capital has moved here as a safe haven, and we should charge rent on the safe haven.

A lot of the capital that is flowing around has never seen taxes. It would be a great experience. But I do believe that the fall in the dollar that will result will push up our inflation, will push up our growth and will push up our interest rates. And that means we are trading in more competitiveness in the traded goods sector for higher real interest rates that hurt other sectors.

I conclude that there is no alternative but to have fiscal changes here, a dramatic cut in the budget. A very dramatic fiscal expansion in Germany, in the United Kingdom and Japan, combined with a worldwide reduction in interest rates.

As the recovery slows, we have to be careful that the real interest rates we have will be an increasing burden on financial stability and we have to ask how can we get rid of them.

Thank you very much.

[The prepared statement of Dr. Dornbusch follows:]

Revised

FLOATING RATES AND THE OVERVALUED DOLLAR*

Rudiger Dornbusch
Massachusetts Institute of Technology

The No. 1 policy problem for the world economy is to achieve a soft landing, locking in the gains fo the past two years. The overly strong dollar has been immensely successful in generating a non-inflationary recovery in the U.S., but has done so at the cost of a very large loss in international price competitiveness. High real interest rates have not stood in the way of a brisk recovery while fiscal expansion pushed the economy, but are now a heavy levy on profits in an economy where growth is becoming moderate. The solution to the twin problems of high real rates and the overvalued dollar is decidedly not a reform of the international monetary system, monetization of budget deficits, or a collapse of the dollar.

The intelligent solution is to correct our budget deficit and, at the same time persuade our trading partners, especially Germany, the U.K. and Japan, that the time has come for them to take the initiative for sustaining growth by long overdue fiscal expansion. In addition, given these fiscal policy adjustments, monetary authorities here and abroad should accommodate a continuing recovery by allowing a decline in real interest rates. Such a policy package would limit the decline of the dollar (and the attendant risk of a steep increase in U.S. inflation) and assures a continuation of world recovery under sounder financial conditions.

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*Statement Before the Committee on Finance of the U.S. Senate, April 24, 1985.

International agreements about intervention, target zones or even fixed exchange rates are altogether implausible as long as Congress and the administration cannot agree on a restoration of fiscal balance. Equally important, exchange rate commitments are premature as long as governments in the countries with excessive fiscal tightness do not cease taking a free ride on the world economy.

Once the fiscal alignments are underway and real interest rates are allowed to ease, the dollar will move down, restoring a sustainable current account. Without those fiscal realignments we should certainly not commit the U.S. to target exchange rate zones. We certainly should not be prepared to monetize deficits in an effort to take the dollar down, and we should resist freezing the dollar at the present level, except as the counterpart of a strong and sustained foreign expansion. Until basic macroeconomic policies are locked in by actions on the budget here and abroad, we should certainly not undertake any exchange rate commitments.

The Strong Dollar

Since 1979-80 the dollar has undergone a massive appreciation in world currency markets. The extent of the appreciation, reaching a peak earlier this year, is shown in Table 1. Even though the decline since the peak in February 1985 is already large, the remaining cumulative appreciation from 1980 to April 1985 is huge. This is particularly clear from the movement in the Morgan Guaranty index for the trade weighted dollar exchange rate.

Table 1 Dollar Appreciation Since 1980

	1980	Feb. 85	April 85	% Change 80-April 85
Yen/$ Rate	226	260	247	9.3
DM/$ Rate	1.82	3.29	2.97	63.2
Morgan Guaranty Index	90.7	136.4	128.5	41.7

Given the attention that Japan is attracting, it is important to recognize that Germany (and Europe) had in fact a vastly larger depreciation. The movements in nominal currency values are already sizeable, but their impact has been reinforced by the fact that U.S. inflation was higher and productivity growth lower than that abroad. As a result, our international competitiveness has been impared by the combined effect of these three factors. The point is perhaps most effectively made by noting the data on hourly compensation in manufacturing in the U.S. and abroad, shown in Table 2.

Table 2 Hourly Compensation in Manufacturing
($ U.S. per Hour)

	U.S.	Japan	Germany
1978	8.30	5.40	9.65
1984	12.82	6.42	9.57
Percentage Increse	53.0	18.9	-0.8

U.S. competitiveness, of course, suffered even further than the wage date in Table 2 indicates, because productivity growth abroad was significantly higher than in the U.S. economy. The deterioration of external competitiveness is quite apparent in comparative industry price data. For example, in the period 1980 to 1984 the price of U.S. exports of electrical and electronic measuring devices increased by 54 percent over the price of comparable imports; for telecommunications parts the deterioration in price competitiveness is 32 percent, 57 percent for thermal household appliances and 48 percent for textile finishing machinery. These are not special cases; the same pattern prevails throughout manufacturing.

The loss in external competitiveness is patently obvious from a number of trade indicators. Table 3 shows data on growth of export and import volumes for several countries in the period 1981-84. Cumulative U.S. export growth has been negative, while import volume has increased sharply. These data are affected by differences in economic growth at home and abroad, but they also reflect our loss in international cost competitiveness.

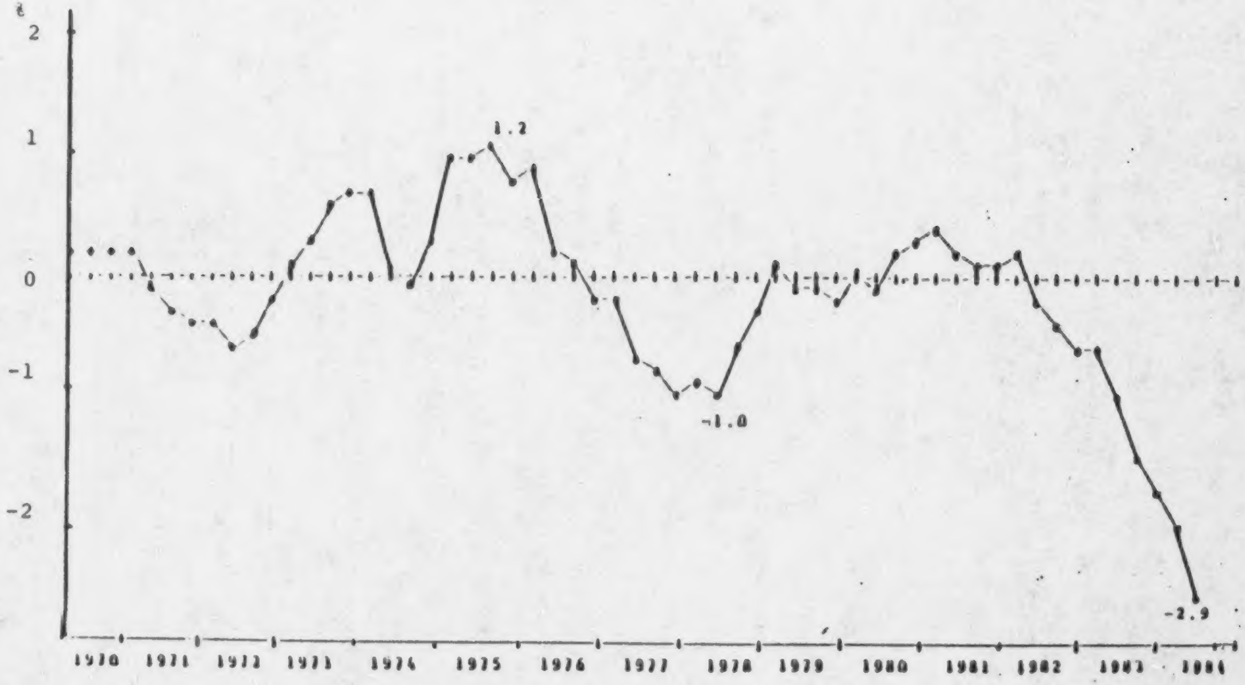
Table 3 Growth in Trade Volume
(Cumulative Percentage Change: 1981-84)

	U.S.	Europe	Japan	Latin America
Exports	-12.7	15.8	32.1	17.7
Imports	27.8	7.0	9.0	-36.9

Source: IMF World Economic Outlook, April 1985.

The deterioration in external performance is summarized in Figure 1, showing the U.S. current account deficit as a fraction of GDP. The deficit

Figure 1
The U.S. Current Account
(Percent of GDP)



is at an all time high. Econometric estimates suggest that as much as 60 percent of the deterioration is due to the loss in international competitiveness. The remainder is accounted for by the relative cyclical position of the of the U.S. and the rest of the world and by the sharp trade adjustment of Latin America. Our spending growth has run strongly ahead of spending increases abroad. This is particualrly true, of course, for debtor LDCs where the adjustment programs have led to increases in their exports and deep cuts in our exports to them. While some of these trade losses may be transitory Latin America is bound to have significantly less access to external capital in the coming years and hence will have to run persistent trade surplusses to earn the dollars with which to pay interest to our banks.

The large divergence between U.S. import and export performance is, of course, the channel through which the U.S. has spread growth abroad. Our spending has increased significantly more rapidly than our income and the divergence has sustained or made possible income growth, budget improvements and debt service abroad.

Dollar Apprecation and the U.S. Economy

The rise in the dollar has been a major factor in the slowing down of inflation in the U.S. economy. The normal pattern is for inflation to fall in a recession, but to show a sharp increase in the recovery. From one business cycle to the next (measured from peak to peak) inflation used to increase, thus ratcheting upward over the past thirty years. That pattern, for the moment, is broken. Inflaiton and wage settlements are low and for the time being do not show signs of the normal cyclical recovery. Several complementary factors that help explain this development follow.

Deregulation and the weakening of unions are clearly important factors. The dominant element is likely to be the record high, and still high, level of unemployment. But the strong dollar must also be counted. The appreciation of the dollar has lowered import prices absolutely and, thus, has directly contributed to disinflation. But the increased import competition has also exerted a dampening effect on the price increases domestic firms could afford, and on the wage increases they could concede. Dollar overvaluation thus has exerted a chilling influence on the entire wage-price setting mechanism. This is particularly the case for raw materials, where the normal cyclical recovery has simply not taken place. The fall in dollar prices of agricultural commodities have helped keep food price inflation and hence wage demands low.

The rule of thumb is that a 10% dollar appreciation reduces inflation by about 1 percent. But that number may be a considerable underestimate of the pervasive effects of a sustained, large appreciation. Taking into account direct effects as well as wage channels, a 10 percent dollar appreciation may reduce inflation by 2 percentage points or even more. Given the size of the dollar appreciation since 1980, this suggests that in addition to unemployment the strong dollar may be the main reason we have been able to enjoy a non-inflationary recovery so far.

The dollar overvaluation has also involved costs, most obviously in the deterioration of manufacturing competitiveness, profitability and employment. Manufacturing has been by-passed in the recovery and this is particularly true for the capital goods industry, excepting space and defense related firms. While total industrial output grew 8 percent since 1979, defense and space related production grew by 58 percent. This suggests a decline of civilian production in the midst of a strong recovery.

The poor performance of manufacturing is reflected in the decline of manufacturing employment since 1979. Figure 2 shows total employment (non-agricultural establishments) as well as employment in manufacturing. While total employment grew by 8 percent since 1979, manufacturing employment today is more than 6 percent lower than six years ago. Part of the reduction in manufacturing employment reflects productivity growth and thus must be welcomed. But that will not go far enough to explain the significant fall. The recovery of the past two years was simply insufficient to make up for the inroads of import competition and loss of exports on manufacturing employment.

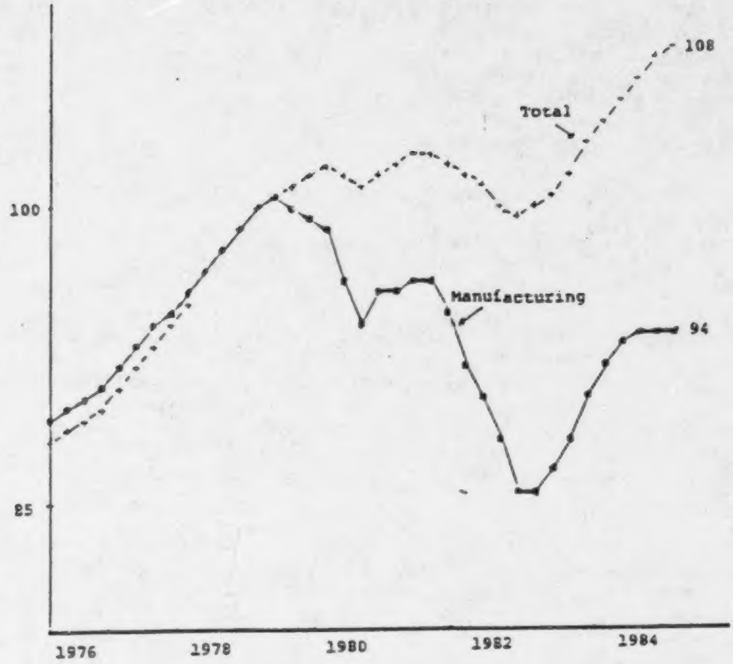
The common argument against excessive fiscal expansion is that it leads to crowding out, as high interest rates displace private sector investment spending and thus growth of potential output and employment. But there is a more immediate crowding out as firms that lose competitiveness cease operations in the high wage country and shift operations abroad. There is accordingly a direct loss of useful capital and of employment opportunities. This process will be more intense the larger and the more persistent the overvaluation. In the U.S., the recovery has for a while overshadowed these effects of the strong dollar, but they are now becoming quite apparent.

Why is the Dollar High?

The strength of the dollar has been explained by three basic arguments: safe haven factors, bubbles, and the divergent policy mix here and abroad.

Figure 2

U.S. Employment Trends
(Index 1979:1=100)



They are not necessarily alternative explanations and each may well have played a role.

The safe haven argument asserts that the U.S. has become a relatively safer place for investment, given increased uncertainty and instability in the rest of the world. It is difficult to put the finger on the increased uncertainty, especially in 1984 and early 1985, when some of the sharpest appreciation occurred. The argument is also surprising in view of the fact that as recently as 1980, the U.S. was definitely not the place sought out by foreign capital. Of course, the Reagan presidency must have made some difference.

The bubble argument emphasizes that asset markets can set prices of currencies, longterm bonds, stocks, or real estate that are unrelated to fundamentals. For example, stock prices might be set in excess of the value of prospective earnings of capital or land prices in excess of the prospective value of rentals. Similarly, currency values might be set outside a range that is sustainable considering the impact of the exchange rate on economic activity or the external balance. Expectations of high capital gains carry these markets and compensate for the fully perceived risk of a collapse to fundamentals. Such bubbles have occurred in the past, and they may well be at work in foreign exchange markets. Bubbles are a serious problem whenever capital gains dominate by a large margin interest differentials. In these conditions the speculation centers on whether further capital gains can be sustained or whether changes in fundamentals could force a shift in the market. In the exchange market this speculation has focussed on the trend of U.S. interest rates and on the strength of the economy. A weakening of rates is seen as the signal that the stampede from the dollar will get underway.

The safe haven and bubble argument have in common that they recognize an overvaluation of the dollar. Nominal exchange rate movements, in this view, have taken the rate away from a sustainable level and, thus ultimately, a collapse is inevitable. The persistence of the exchange rate at this disequilibrium level in turn is seen as distorting resource allocation. An alternative approach argues that the fundamentals have changed and thus warrant a high value of the dollar, even if it is troublesome for some sectors and unwise as a policy. The argument focusses on fundamentals in that the U.S. and other industrialized countries have followed a sharply diverging trend of policies which is responsible for the dollar appreciation.

Table 4 shows data on fiscal policy that support this view. Where the U.S. has shifted dramatically toward a deficit in Germany, other European countries and Japan have moved in the opposite direction with as much vehemence.

Table 4 Government Budget Trends
(percent of GDP)

	Actual Budget Deficit 1984	1985	Change in Adjusted Budget Deficit: 1980-1985
U.S.	3.2	3.6	-4.5
Germany	1.7	0.9	+4.2
Japan	2.2	0.8	+3.2

Note: The adjusted deficit data are corrected for the effect of unemployment and inflation.

The divergent shift in fiscal policy was reinforced by a much stronger increase in interest rates in the U.S. compared to the rest of the world. Even today U.S. interest rates exceed those in Germany or Japan by more than 250 basis points and by even more when adjustments for inflation are made. The longterm interest differential, between the U.S. and Germany or Japan, exceeds 400 basis points. If the probability of a dollar collapse were negligible these differentials would imply a really huge incentive to hold U.S. securities. As it is, that possibility cannot be ruled out, but in the early stages of the recovery it may well have been the case that depreciation was as likely as appreciation, thus leaving a net incentive to shift toward U.S. securities.

The strong dollar can thus be seen primarily as a reflection of monetary and fiscal policies here and abroad. The dollar is clearly overvalued from the point of view of manufacturing, but even so our aggregate growth performance has been above average by the standards of post war recoveries. Without a deterioration in our trade balance, the growth in 1983-84 would have been entirely unreasonable and the interest rates, in the absence of accommodation, would have shifted difficulties to housing and interest-sensitive manufacturing sectors. Given the enormous fiscal stimulus crowding out was simply unavoidable, except if the Fed had chosen to accommodate even higher growth by an exchange rate oriented monetary policy which might have meant a very strong monetary growth so as to monetize the deficits. The only choice would have been to take the crowding out in interest-rate sensitive sectors rather than in the external balance. As it is, our growth during the recovery has been above average for the post-war period; asking for more is unreasonable.

The Exchange Rate System

For at least 100 years the international monetary system has been considered inadequate, whatever the arrangements: the gold standard, bimetallism, the gold exchange standard, dollar standard, fixed rates, managed rates and floating rates. Throughout the inter-war period international monetary conferences sought to cope with the conflicts posed by divergent national policies and interests. The problems were not solved then, nor at Bretton Woods, the Smithsonian or Rambouillet. They will also befuddle any new initiative the U.S. Treasury might promote.

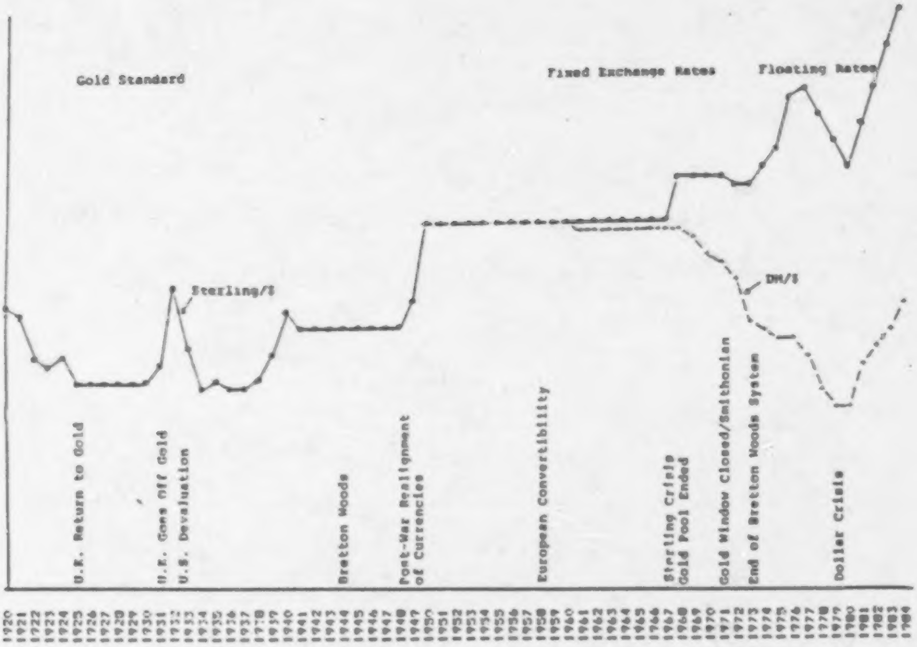
Figure 3 shows the international monetary system in the past sixty years in the light of two key exchange rates: the sterling/$ rate was the center piece until the 1960s; and the Deutsch Mark/$ rate has been the focal point since. Our problems today are not unlike those of 1931-32 when every country sought to gain employment by competitive devaluation or undervalued currencies. Again in 1971 the U.S. was faced with overvaluation. At that time President Nixon devalued the dollar and imposed an import surcharge. Here is a quote that sounds uncomfortably familiar today:

> "As a temporary measure, I am imposing an additional tax of 10 percent on goods imported into the United States...It is an action to make certain that American products will not be at a disadvantage because of unfair exchange rates. When the unfair treatment is ended the import tax will end as well...The time has come for exchange rates to be set straight and for the major nations to compete as equals. There is no longer any need for the United States to compete with one hand tied behind her back." (Quoted in J. Odell, U.S. International Monetary Policy).

Those who call for a step in the direction of international monetary reform all start from the premise that flexible rates have failed. A strong

Figure 3

The International Monetary System
(Exchange Rate Indices,Log Scale)



advocate of that position is C.F. Bergsten, who has argued recently (NY Times, April 21, 1985):

> "It is clear that the monetary system is failing in its basic purpose of accurately equating the competitive positions of national economies. Its reform is essential to achieve and maintain a healthy world economy."

These complaints about the behavior of the flexible rate system are misplaced; they command as much persuasion as a drunk driver complaining, after the crash, that cars are simply not safe. The fact is that the extreme divergence of the policy mix in the U.S. and abroad is to be blamed, not the exchange rate system. U.S. growth has been high, above average for a recover, despite record high real interest rates and high dollar. That suggests that some very peculiar policies were in place. Moreover, there is no reason to single out exchange rate difficulties, neglecting the high real interest rates as a very damaging feature of the recovery. A balanced, open-minded approach will focus on both distortions to balanced growth.

It used to be said that exchange rates fail to function properly when they do not lead to balanced trade or balanced curent accounts. That view is no longer fashionable because it is recognized that international borrowing or lending need not be all bad. The new version shifts to "equating underlying competitive positions of national economies", which one assumes means exchange rate movements that do not deviate too much from purchasing power parity levels, whatever the consequences for national unemployment rates. But suppose that the dollar had, indeed, been maintained in line with inflation differentials. Our much stronger external balance would have added yet further to growth and also to inflation. Growth abroad would have been much smaller and unemployment correspondingly higher. But abroad, the unemployment problem is already very serious indeed. In Europe unemployment is now 11.3 percent and rising, even with the strong dollar.

Even with the overvalued dollar, Europe feels that real wages are too high to have full employment. With a weaker dollar their unemployment problem would be much worse. The point of all this is that the dollar cannot improve both Europe's unemployment and our manufacturing problems at the same time. Without a deliberate shift in underlying monetary and fiscal policies, exchange rate fix-ups are simply beggar-thy-neighbor policies that are unlikely to succeed because the rest of the world badly needs remedies for unemployment, even as we hope to improve our manufacturing profitability. If that point is conceded we might as well speak directly of the required policy changes that will simultaneously cope with dollar overvaluation and overly high real interest rates, rather than pretend that exchange rate fix-ups miraculously solve all inconsistencies of national macroeconomic policies. That would lend a welcome realism to the discussion because it would make clear that we are talking about European and Japanese fiscal expansion and U.S. budget cuts, and about sharply lower real interest rates.

No international monetary system can cope effectively with sharply divergent macroeconomic policies, especially under conditions of international capital mobility. The Bretton Woods system came under pressure in the late 1950s and thoughout the 1960s, because the U.S. policy mix was not acceptable to our major trading partners. To escape from dollar overvaluation under fixed rates the world went to flexible rates, which now are said to have failed. Moving to more rigid rates will not cope with the problem of integrated capital markets and divergent fundamentals. Limiting exchange rate movements, without internationally agreed target zones for budgets and for real interest rates, is simply absurd.

The reason is that there is no instrument available to implement the exchange rate commitment. Policy instruments to affect exchange rates are primarily monetary and fiscal policy. With the right fiscal policy still out of reach monetary policy would have to do whatever is necessary to make the exchange rate stay within bounds. But, of course, few people would be foolish enough to argue that the monetary policy should be geared to defending the exchange rate, at any price. In the U.S. conditions of 1983-84 that would have meant monetizing budget deficits and preventing disinflation altogether. It is therefore surprising that as impracticable an alternative as target zones should continue to attract public interest and the support of some policy advisors.

We have already discussed above the merits of changes in monetary and fiscal policies. If such policy changes were made it is not obvious why there would be any further need for exchange rate targets. But if these more basic changes in macro policies were not to occur in the near future, are there alternatives? Target zone supporters might hope to implement their exchange rate objectives either via changes in underlying macroeconomic policies or via foreign exchange market intervention. With unchanged monetary policy intervention will have to be sterilized. That means the world supply of public debt would be reshuffled between dollar and DM denominations.

The effectiveness of sterilized intervention has not been established and therefore we should not oversell the scope for intervention to achieve orderly exchange rate movements. A significant body of research produced by the Federal Reserve leads to the conclusion that intervention with unchanged monetary and fiscal policies does nothing to exchange rates. Indeed, the effectiveness of intervention would at best be limited to creating outright "disorderly markets" in an effort to depress the exchange rate. That is an effective way to burst a bubble but is neither effective nor, indeed, appropriate in the case of an equilibrium exchange rate that is high because underlying policies call for a high rate. As to the bubble case, the logic that calls for bursting bubbles carries over to bond markets where disorderly markets should be created to bring down overly high longterm rates by pushing up bond prices.

Economics has as yet no definite criteria for establishing whether a particular economy-wide asset price represents a price that optimally allocates resources between alternative uses. We use the presumption that the free market knows best, but have to confess to some uncertainty on this question. But it is equally important not to throw all organised thinking overboard and react to manufacturing problems by a piecemeal fix-up of the exchange rate, as if there were no concern for economy-wide interactions. Anyone who is willing to act on the exchange rate must also be willing to announce views and actions on interest rates and the stock market. They are part of the same economy-wide price system and determine, in conjunction with fiscal policy the level of ouput, employment and the allocation of resources in the world economy. It is not appropriate to think that one single price--the exchange rate--can be identified as "wrong" and moved around at will without world-wide effects on every other price. If the dollar could be talked or intervened down without changes in monetary and fiscal policy then we would, in all likelihood, have higher interest rates. It is difficult to believe that a lower dollar and a higher interest rate are any better than what we have now.

The best of all worlds would be one where policy makers can draw on international exchange for the gains from trade, but isolate economies from the spill-over effects of macroeconomic policies and disturbances. We would like strong exchange rates for disinflation, but then avoid the import consequences. We would like to draw on capital inflows to hold down interest rates, but would like to avoid running trade deficits or incur foreign debts. For better or worse, there is no way we can run smaller trade deficits, have higher growth and lower interest rates, except by a reversal of the past few year's policy mix here and abroad.

Neither an import surcharge nor capital controls are a substitute for a change in fundamentals.[1] An interest equalization tax to reduce the attractiveness of U.S. assets to foreign holders is the proper response to a bubble or to safe haven capital flight into the dollar, which as a result becomes overvalued. A restoration and increase of the witholding tax on foreign holders of U.S. assets would be altogether appropriate, if only as a way of charging rent on the safe haven. The policy would yield some revenue in the process of taxing foreign asset holders that may otherwise escape taxes altogether. There would be little doubt that the dollar would decline as a result, perhaps precipitously. But the weakening of the dollar would leave us still with the problem of the right policy mix. The weaker dollar would increase (or sustain) growth, but it also would raise interest rates and, thus, merely shift the crowding out to other sectors of the economy. The basic problem that needs attention therefore is to correct the policy mix here and abroad.

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[1] I have critized the import surcharge idea in an editorial entitled, "The Illusions of Protectionism," in the Los Angeles Times, April 4, 1985.

The **Chairman**. Doctor, how easy is it to correct the damage that we have already done to our manufacturing base? If we narrow the deficit, if we increase taxes or cut spending and things get better, can we get it back?

Dr. **Dornbusch**. Well, we certainly in 1978 were highly competitive and only 6 years later we are complaining that things are very bad. There is no doubt that if the dollar came down somewhat and growth abroad was much stronger our manufacturing problems would be much, much less than they are today.

We have an adverse trend because every LDC is now producing with our technology. Our wage and manufacturing is $12. Theirs is $2. So we will have a little bit of a problem over the next 20 years. The dollar is only a small fraction of it. We will have to cope with the policies by much lower real interest rates, much stronger investment in the U.S. economy and with a stronger export sector, which the import surcharge would hurt.

The **Chairman**. Did I understand you correctly? We will have a slightly difficult problem over the next 20 years?

Dr. **Dornbusch**. I do think so; yes.

The **Chairman**. I don't think I will be here that long, but I will call upon Senator Baucus for questions.

Senator **Baucus**. I'm not sure I want to be here that long.

Dr. Dornbusch, essentially what I hear you saying is that we should get our fiscal house in order and don't worry much about anything else—capital controls or import surcharge or intervention or most anything else. But just basically get our fiscal house in order. Is that your message?

Dr. **Dornbusch**. That's right. Because we can't avoid doing that sooner or later. And any fix up will in the meantime make some things worse. Capital controls are the best, but even they will not help.

Senator **Baucus**. I'm a little curious at your reluctance to endorse currency intervention. As you know, one of your colleagues at MIT, Lester Throw, thinks that it's a good idea. I'm just curious what is the main source of the difference of opinion. Why is it that you think it won't work as he thinks it will work?

Dr. **Dornbusch**. I must confess I haven't talked with him about intervention, but I can explain it here and to him later why it cannot work.

Sterilized intervention means we are changing the relative supplies of dollar denominated bonds and deutsche marks denominated bonds. The U.S. Treasury today announces that they are retiring half the U.S. public debt and substituting DM bonds for them. That's what sterilized intervention is.

The risk premium that are attached to currency denominations are very, very small. Therefore, changes in the relative supplies have estimated effects only of the order of three, four, five basis points. Not percentage points, basis points.

We had a comparable experience in the United States when we tried to change the term structure of interest by reshuffling the composition of debt between long and short. And people who looked at the effect, and who are still looking, never really found any. It's much the same if the U.S. Government started borrowing in deutsche marks rather than in dollars.

Senator **Baucus**. Do you think that the now amazing efficiency in the flow of capital around the world—nearly instant 24-hour capital markets—has any bearing at all on the value of the dollar?

Dr. **Dornbusch**. I think it has very little to do with it. If you look at the experience under flexible exchange rates in the 1920's and 1930's, you have as extreme experiences of overvaluation and undervaluation. It may be true that now the average speculator thinks that they can get out even faster than before, but surely they must also know that everybody else thinks the same, and that together they can't.

So, my impression is that the enhanced ability to move money around really doesn't make a difference. If you look at monetary history, we have seen exactly the same thing before. Every time you have extreme policies, and the exchange rates are flexible, real exchange rates can move 30, 40, 50 percent.

Senator **Baucus**. Is it true that during the first years of the fixed exchange rate system somewhat the same phenomenon occurred? Namely, that countries wanted to hold dollars even though fixed rates made it more difficult? But the same desire was there. Is that correct?

Dr. **Dornbusch**. Well, countries have held dollars as reserves in order to——

Senator **Baucus**. Was there a desire to hold more dollars which then helps drive up the value of the U.S. dollar compared to other countries' currencies?

Dr. **Dornbusch**. I do not think so. I think that during the 1950's and 1960's, Europe was very glad to have an overvalued dollar as a way to export. For the same reason now, they have no great excitement to get the dollar down, given the unemployment problems of many of these countries.

Senator **Baucus**. Right.

Dr. **Dornbusch**. Reserve holdings, I think, have little to do with it.

Senator **Baucus**. What's your view of a surcharge?

Dr. **Dornbusch**. I think a surcharge is an awful idea.

Senator **Baucus**. Why?

Dr. **Dornbusch**. Well, all the right things have been said. The first point I want to make is that if we compare a surcharge as the fiscal device, we will have to ask what else would we do. Compared, say, to a consumption tax, it would keep up growth—that's a good thing, but that would mean we would have higher interest rates with the same monetary policies and more inflation. Real interest rates would be higher, capital will flow in, the dollar will go up. That means we are financing the budget essentially by an export tax.

If the thing is transitory as proposed by Motorola, it ceases during the next Presidential election and then we have to decide are we going to raise taxes to balance the budget, or do we keep the surcharge.

Senator **Baucus**. I agree with you. Thank you very much.

Thank you, Mr. Chairman.

The **Chairman**. Senator Long.

Senator **Long**. Doctor, recently I was at a meeting where some American manufacturers were discussing the trade problem. They seemed to think that with technology, which was once the advantage that we had we now have provided that to Asia and to the whole world, and low wage and other standards in the Asian area, our manufacturing people are put at a tremendous disadvantage. In some areas, wages are around $0.30 an hour, plant costs are minimal compared to ours. For example, one American businessman said at such a meeting that he had invested some money in a plant either Burma or somewhere near Burma, where they are making the best rattan furniture in the world. The investment is profitable. He suggested that they ought to put on a second shift so that they could produce more furniture and make more money. And the plant manager said, "Oh, you wouldn't want to do that."

He said, "Why." The manager said, "Because you would have to put lights in this place if you had a second shift."

In other words, the plant cost only a fraction, a small fraction, maybe 15 percent of what it costs over here.

And do you think that if we can do what you are suggesting to try to affect the currency ratios that that is still going to make us competitive in a free trade sense with the kind of manufactured goods that are moving from Southeast Asia and Korea and places of that sort?

Dr. **DORNBUSCH.** Our trade problems with LDC's have very little to do with the strong dollar. The strong dollar is mainly an issue between the United States and Europe. The LDC's have very low wages. They have taken advantage of our direct investment there, our technology and for the next 100 years they will become increasingly competitive. Now we really can't do very much about it. The only thing we can try is to invest—to earn our own wages in industries where we can potentially sell to them. That means we have an interest in open markets abroad, but at the same time we have certainly no interest in trying to exclude LDC's from our market. In fact, if we did it, the very first thing they would do is stop paying us interest on their debts.

We are in a bit of a problem in that we are forcing LDC's to pay the interest. The only way they can pay is with exports with us. The only way they can earn the exports to us is by depressing their dollar wages. So if we complain about the wages, we should cheerfully look at the interest we are collecting. Or we forgive the interest, and then they can spend it on our exports.

Senator **LONG.** Well, if we can persuade those people to buy commodities from us, even farm commodities, that might help to find a way to pay for it.

Now Red China is coming on and it seems to me that it might be good for us if we can find a way to adjust ourselves to what Red China's potential is likely to be, as that enormous country finds ways to move toward—hopefully, a free enterprise system. I gain the impression that in any area where the labor cost is a major part of the cost—any labor intensive operation—they will be in a position to sell below us. Is that correct or not? What do you think?

Dr. **DORNBUSCH.** Well, it's certainly true that China will make a major change among the LDC's. I think China is more of a threat to Korea than to us because their products will likely be much more labor intensive than anything we could make. Much lower quality. So Korea is concerned about China, but our interest, of course, is that we do want to sell to them, and the question is whether Korea is better at that, too, than we are.

Senator **Long**. Thank you.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

Dr. Dornbusch, you had a very succinct set of analyses and recommendations. The last one was that we are faced with only two things that we can do—get our budget deficit down and put capital controls on. On the budget deficit, should we cut spending or raise taxes?

Dr. **Dornbusch**. We certainly should do both. But on the tax side inevitably find a broad based tax.

Senator **Bradley**. So that we should do both and the form of tax increase that you would like to see is what?

Dr. **Dornbusch**. A broad based tax on expenditure or consumption or value added. The exact base matters much, much less than the fact that it be very broad based.

Senator **Bradley**. Should it be raised through the income tax system or through some other form of tax, such as the ones that you have mentioned?

Dr. **Dornbusch**. I have no strong preference between them. Whichever you can do this year.

Senator **Bradley**. When you say "capital controls," you said that what we ought to do is charge a rent on safe haven aspects of the foreign capital that flows to the United States. What percent of the $100 billion is here for safe haven reasons and what percent do you think is here because of real interest rate differential reasons?

Dr. **Dornbusch**. I would think that a large part is for real interest rate differential reasons. The safe haven one can get in Switzerland or in other places. So I would have a difficult time allocating. I would think that it's more than $100 billion, though. Foreign-owned assets in the United States would be significantly more than that.

Senator **Bradley**. How would you charge a rent on safe haven by the use of capital controls? How would you be able to get the rent through capital controls?

Dr. **Dornbusch**. We repealed the withholding tax on the foreign held assets in the United States. Instead of repealing it, we should have doubled it.

Senator **Bradley**. All right.

Dr. **Dornbusch**. Now that will not get at all forms of capital.

Senator **Bradley**. That was my next question, and I'm glad that you got to it.

Therefore, you think that even though only a portion of the funds that are placed here by foreigners are placed here for safe haven reasons, that we should, indeed, reinstitute and perhaps double the withholding tax on foreign capital income in this country. Is that correct?

Dr. **Dornbusch**. Certainly so. And I wouldn't go out of my way to make a difference between safe haven and others.

Senator **Bradley**. All right. I was only asking because that leads to the next question which is: Do you believe the argument that if we put the withholding tax in and increased the withholding tax on foreign capital income in this country—do you believe that that would not cause the income to the capital to move abroad? Do you think that the withholding tax would not offset the advantage or either safe haven or real interest rate differential?

Dr. **Dornbusch**. I would think that some people would shift out of U.S. assets and that as a consequence the dollar will fall. But we are concerned that the dollar is too high, so we want to ask how do you get it down. I see two ways. You can put an import surcharge and give the proceeds to exporters. Or you can tax capital.

Senator **Bradley**. All right. Do you then assume that the movement out of the dollar into other currencies would not be so precipitous as to raise interest rates here domestically?

Dr. **Dornbusch**. That is the difficult problem with it that I raised. When we get the dollar down in that way, then we have gotten high interest rates in exchange. We will stop the problem for those manufacturing industries in international trade and make it the normal fiscal problem of crowding out for interest sensitive industries.

Senator **Bradley**. So do you agree that one way to look at the whole trade deficit and also the capital accounts is that it is simply a choice between whether we want manufacturing America or those elements of the financial industry that sell government securities to prosper?

Dr. **Dornbusch**. Indeed, sir.

Senator **Bradley**. Thank you.

The **Chairman**. Doctor, so just our definitions are right. When you say "broad based tax," what do you mean?

Dr. **Dornbusch**. I mean something like all of consumption, all of expenditure, or income taxes rather than a tax on gasoline or a tax on imported oil which may have merits by themselves, but which are really a piecemeal way of trying to get $100 billion.

The **Chairman**. So you are not necessarily talking about a tax that proportionately falls on income classes in proportion to the totals. You are simply saying it's going to affect all income, all consumption, with no exemptions?

Dr. **Dornbusch**. That's right.

The **Chairman**. And if we have a sales tax, there is not going to be exemptions for food and clothing and pharmaceuticals. And if we have an income tax, there is not going to be exemptions for mortgage interest deductions or a special rate for capital gains or something like that.

Senator **Bradley**. Mr. Chairman, may I follow up with another question?

The **Chairman**. Yes.

Senator **Bradley**. I found your testimony very interesting. I'd like to follow up on a question Senator Long asked about Third World wage rates and competitiveness with the United States.

Given that you have laid out this scenario, if Third World countries cut their wages, they won't be able to repay our interest; and you have put us in a position in that analysis where we are locked out essentially.

What do you put as the chances or the advisability of simply saying, look, we are going to lift that burden off the backs of those countries by essentially asking the banking sector to take a share of losses, reschedule that third world debt, lower interest rates, longer terms. Would the world's financial system, if we were able to do that, be more solid and do you believe we can get from where we are now to there?

Dr. DORNBUSCH. I would certainly believe that that would be an excellent move to assure the stability of the world's financial system. Indeed, and we would have less import penetration in U.S. markets from countries like Brazil or Mexico that have to try and be employed to use the money to pay our interest.

Senator BRADLEY. Would you expand on that? Why would there be less import penetration?

Dr. DORNBUSCH. At present, there is relatively little lending by banks. They lend less than the full interest bill. So most of the interest bill has to be earned by those countries either cutting down on their imports from us and other countries or increasing their exports to us.

If we look at the United States, we have had a fall in exports and we had import growth of, I think, 20 percent over the last 3 years. We look at the—Latin America as a group. Export growth 30 percent, import minus 20. Well, our manufacturing problem in part is the dollar, but in large part is that LDC's have to earn dollars to pay interest to us and that means they buy less from us, they send more to us.

To say all the trade problems are the dollar is really a big mistake. Half of them are the European's deep, deep recession and the deficit and interest problems of LDC's.

Senator BRADLEY. So that what you are saying is that we have a choice here once again between whether we want interest to be paid to financial institutions or whether we want the manufacturing sector, whether it's export or import, to improve.

Dr. DORNBUSCH. I'm afraid we don't have that choice because we can't make the banks not collect. And if we could, that would be excellent.

Senator BRADLEY. But if you restructured, if you restructured, they would have less income; they would have to write off a certain portion of those debts, and the lesser income would be reflected in lower earnings. And the third world would not have to pay as much interest. They would, therefore, not have to push as much on exports and could purchase more U.S. imports. Right?

Dr. DORNBUSCH. Certainly.

Senator BRADLEY. Have you thought about how we get from where we are now to the restructuring?

Dr. DORNBUSCH. I've written on that. I'm happy to send you some material.

Senator BRADLEY. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. Doctor, one of our problems is that there are a number of things that we are financing that we could better finance through taxes on imports that are not so-called GATT-legal. We can't impose those taxes on imports. For example, unemployment insurance, welfare benefits, cost of our full employment program, Social Security, minimum wages, environmental matters, matters related to safety, compensation for injury, health benefits, and all those things are financed by domestic taxes exclusively.

And in negotiating the GATT agreement, whoever was representing us at that time over there in Geneva agreed that we could not treat such taxes the same way foreign countries treat their value added taxes. They finance those types of benefits with value added taxes, and we are financing such benefits with our Social Security tax, and they can meet us with a border tax to pay for the value added tax and we can't do the same thing to them when they ship in our direction with our FICA taxes.

Now if we would shift our way of taxing to pay for all these benefits, finance it with something like a value added tax—anything that is so-called GATT legal—we would then be in a position to charge it on the imports. And that would tend to improve our competitive position.

Have you thought about that approach?

Dr. DORNBUSCH. I believe we are able to rebate—it's a production tax. I'm not certain, but I don't think we could charge on imports, but I don't want to say for sure.

Senator LONG. Well, if——

Dr. DORNBUSCH. If we are charging on exports, I'm not certain whether we would charge on imports.

Senator LONG. Don't tell me that you have any doubt in your mind that if we financed all these matters with a value added tax that we could do the same thing with our value added tax that all those European countries are doing. In other words, we would have a right to charge that on the imports as well as on the—on our manufactured products.

Dr. DORNBUSCH. Perhaps I can answer the question this way. If we shifted to a value added tax, that shift under the GATT rules would not allow us to discriminate against imports.

Senator LONG. I'm not talking about discrimination. I'm talking about making them pay the same tax that we are paying. If we have a value added tax, we certainly have a right to charge it at the border.

Dr. DORNBUSCH. We can eliminate the taxation that is implicit on our exports, but I don't believe that we can charge on imports. We don't have the uniform import surcharge at the rate of the value added tax. I don't believe so.

Senator LONG. Well, I once asked Olivier Long, an old relative of mine but I don't mind his name at all—he was Secretary General of the GATT, the General Agreement on Tariff and Trade—if we substitute our value added tax or if we put a value added tax on our products and charged it at the border, could the Europeans complain about that? He said, "No way can they complain about it. How can they complain about you doing to them the same thing they are doing to you?"

The CHAIRMAN. Do they assess a VAT when they take our imports in now?

Senator LONG. Of course they do.

The CHAIRMAN. I don't think so.

Dr. DORNBUSCH. I really can't give the answer. I'm sorry.

Senator LONG. Well, let me ask if there is someone in the room here who knows the answer to that?

Mr. FOX. I'll be testifying in a minute, Senator. There is no question that a value added tax can be rebated on exports and applied at the border. Dr. Dornbusch is incorrect in that regard. Your statement with respect to the GATT is correct. If we had a value added tax, it could be charged on goods entering the country at the border.

Senator LONG. That's my understanding.

Now Lester Throw is a colleague of yours at MIT, is he not?

Dr. DORNBUSCH. Yes, sir, he is.

Senator LONG. He advocates a value added tax. And he makes a point to me and to other Senators who have discussed it with him that a value added tax need not be a regressive tax if you couple it with a tax credit and even a negative income tax to give whatever credit you want that gets an income tax, and particularly a negative income tax. So that if you look at the mix of a value added tax taken with what you can do with a negative income tax, you could come up with a mix that is every bit as progressive as what you have right now, if you wanted to work a value added tax into it.

Now is that correct or not? What do you think?

Dr. DORNBUSCH. That is certainly correct. Yes.

Senator LONG. Thank you very much.

Dr. DORNBUSCH. I do have also the answer to an earlier question you asked. It's 1,351.

The CHAIRMAN. 351?

Dr. DORNBUSCH. 1,351 billion, the Eurodollar market.

The CHAIRMAN. Instead of 200, 1,351.

Senator LONG. 1,351 billion. Well, I thought that was a little low. [Laughter.]

The CHAIRMAN. Thank you very much, Doctor.

Now we will conclude with Mr. Larry Fox and Mr. Rudolph Oswald.

Mr. Fox, why don't you start?

STATEMENT OF LAWRENCE A. FOX, VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. FOX. Thank you, Mr. Chairman.

I would like to go directly to the solution of the problem, which does have an element of the exchange rate to it. I believe the concentration on the budget deficit, on the subject of better coordination of macroeconomic policies between ourselves and other countries are correct assessments and fundamentals, but I think there is a role for an improvement in the exchange rate regime and I wish to make my comments with respect to that role.

Before doing that, I would like to point to these two charts here, which you also have at the back of my testimony as exhibits 1 and 2.

The first chart compares global trade balances of manufactured goods for the United States, Germany, and Japan. Starting in 1970, going to 1984.

Senator LONG. Which line is which? The red is——

Mr. FOX. The United States is blue, the bottom line; Germany is green, the second line; Japan's is the top line.

In the 1970's we had a small trade surplus or deficit and then we really went down beginning in 1981. Germany and Japan started out in 1970 at about a $15 billion in manufactured goods surplus. Germany went up to about $60 billion in 1980-81 and then leveled off. Japan keeps on going up and is now at $120 billion plus.

The point of my observation is that these results cannot be a true representation of the relative competitiveness or strength of the American industrial economy. It has to be a representation of something else. I am suggesting it is primarily a representation of the exchange rate regime, particularly the beginning of the strong dollar at the end of 1980 when these dramatic changes began to take place.

The second chart relates the U.S. trade balance to the current account balance. For many years, we were able to earn enough in the nontrade portion of the current account balance to make up for a good part of the trade deficits. This, again, changed at the beginning in 1980-81 and has now brought this dramatic decline where the trade balance and the current account balance are both over $100 billion.

The reason I have emphasized the two charts is that I feel that our international accounts are basically out of balance. I do not agree with Dr. Klein that a change in the exchange rate would soon bring about a change in the current account, and things would be as they were in previous periods.

The reason I disagree is that there has been a fundamental change in the structure of our current account. The manufacturing trade balance is minus and it is a structural minus. In addition, you have the Federal Government borrowing abroad for the purpose of helping to finance the budget deficit. According to the Department of Commerce, last year the Federal Government paid out $20 billion in interest to foreigners holding U.S. debt issues. I think the structural change will make a tremendous alteration in our economic activity, and I think the traditional view that Dr. Klein took with respect to the current account is not likely to be the situation in the future. There has been a fundamental discontinuity for the reasons that I have cited.

Now to go directly to the point of my observations on the solution to the exchange rate problem. If I might comment a bit on the discussion this morning, I think there is too much "either/or," when you have got to do both. It is obvious you have got to do the budget deficit question. The sooner the better. And the only question is how soon do you do it.

So don't ask the question: Will you have enough time to do something else? I have as the last exhibit—No. 6—in my paper an NAM statement prepared a couple of weeks ago as to how we go from here to there; that is, from dollar overvaluation to dollar realignment in the context of an improved international exchange rate system. There are nine points, and I will just summarize them briefly, beginning on page 2 of that last statement in my testimony.

First, reduce the budget deficit. And do so in a significant and sustainable way.

Second, change the mix of economic policy here and abroad. This convergent theory is right. Take steps to help Europe grow faster and particularly Latin America to grow faster. That will help our export position and bring about other fundamental improvements in the world economy.

Third, speed up the internationalization of the yen. The Japanese have achieved success in trade through something more than just good management and hard work. They have basically had an undervalued currency since 1965. There was a brief period in the 1970's when the undervaluation was moderate, but basically all along Japan has had the benefit of an undervalued currency and has that benefit today.

Four, take steps to reduce some of the unnecessary demand for the dollar. The dollar is used as a convenience currency. That's fine. But there is no reason why when Germany settles a trade debt with France, an international debt with France, they should go through dollars and create an unnecessary demand for dollars. The Europeans have the same view of the function of the snake and they themselves are looking for ways to cut down on the unnecessary use of the dollar. At the same time that is done, take other steps to——

The CHAIRMAN. Can you wind down, please?

Mr. FOX. Yes, sir.

Take other steps to use other currencies, particularly the yen and the mark, and world reserves. Increasing their use would increase demand for those currencies and to raise their price.

I particularly urge that between now and the 4th of July we begin to work with other countries with respect to coordinated currency intervention with the objective of capping the dollar. There was no reason to have that rise in the dollar's value yesterday of 2 percent. We had a movement which was going in the direction of creating a stronger mark as well as other currencies. If there had been central bank cooperation, that rise would have been prevented, in my opinion, at rather little cost.

May I say one more thing? The observation about billions and billions and billions of dollars crossing the currency markets each day. A lot of that is just cross trade, having very little meaning. One estimate by a very good bank in New York—good, I suppose, because I agree with them—is that the long-term capital movements in a day are only half a billion dollars. Well, if governments, through cooperation of central banks, had a strategic plan, knew what they wanted to do—namely, cap the dollar today and then gradually see it drop in value—coordinated intervention could bring about much greater results, in my opinion, than is commonly supposed. And without massive currency intervention.

So the purpose of intervention would be strategic for specific objectives at specific times. It would not be to overwhelm the market.

And I would conclude that it's necessary to address the longer term evolution of the floating exchange rate system. This would add credibility to the foreign currency operations I have just described.

The CHAIRMAN. I would ask you to stop.

[The prepared statement of Mr. Fox follows:]

National Association of Manufacturers

TESTIMONY OF

LAWRENCE A. FOX
VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS
NATIONAL ASSOCIATION OF MANUFACTURERS

ON

THE DOLLAR EXCHANGE RATE AND THE U.S. TRADE DEFICIT

BEFORE THE

SENATE FINANCE COMMITTEE

APRIL 24, 1985

1776 F Street, N.W. • Washington, D.C. 20006 • (202) 626-3700

SUMMARY OF

LAWRENCE A. FOX
VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS
NATIONAL ASSOCIATION OF MANUFACTURERS

TESTIMONY BEFORE THE

SENATE FINANCE COMMITTEE

APRIL 24, 1985

The massive and still growing U.S. trade deficit reached $123 billion last year and is still growing. Most of the deterioration in our trade has occurred in manufactured goods which, unfortunately, last year contributed $50 billion more to decline in the trade balance. It is universally recognized that the trade deficit is mainly caused by the high value of the dollar, which has risen by 65 percent since 1980 against a basket of 10 industrialized countries. All industrial sectors have been affected, with the sharpest downturn having taken place in the high-tech sector. The President's Council of Economic Advisors has estimated that the causes of the high dollar have had different weights during the past four and one-half years of the dollar's rise, but no one disputes the major role played by high real interest rates in the U.S. in attracting foreign capital. It is obvious that high federal budget deficits play a major role in sustaining high interest rates.

It is generally recognized that about half the trade deficit is due to the high dollar. Trade Ambassador Brock has estimated that it may be as high as 80 percent.

NAM's Board of Directors on February 10, 1984 unanimously adopted an exchange rate resolution calling for a program of action to secure a realignment of the dollar with other major currencies. That program recognized the importance of getting the budget deficit down but also recognized the need to speed up growth abroad, to internationalize the yen, to improve the operation of the floating exchange rate system in cooperation with other major countries, and to work toward a longer-term improvement in the exchange rate system itself.

On April 10, 1985 NAM released a detailed plan calling for immediate action along the lines just indicated and specifically linked progress in the proposed new GATT round of trade negotiations with parallel action in the exchange rate field. We urge the Bonn Economic Summit of May 3-4 to specifically endorse this dual-action approach.

However, we need not wait for the summit nor for trade negotiations to get started on the job of first capping the dollar's value and then working toward dollar realignment. Note, however, that success depends on decisive and early action on the federal budget deficit.

Finally, it should be recognized that there are other major factors negatively impacting our competitiveness and trade performance, not just the high dollar. These factors include our own anti-export laws, insufficient access to many important foreign markets, and certain foreign industrial policies, subsidies and other measures that distort markets.

TESTIMONY OF

LAWRENCE A. FOX
VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS
NATIONAL ASSOCIATION OF MANUFACTURERS

ON

THE DOLLAR EXCHANGE RATE AND THE U.S. TRADE DEFICIT

BEFORE THE

SENATE FINANCE COMMITTEE

APRIL 24, 1985

Mr. Chairman, members of the committee, I am Lawrence A. Fox, Vice President for International Economic Affairs of the National Association of Manufacturers. NAM is the nation's oldest national trade association, with membership of more than 13,000 companies, ranging from the smallest to the largest companies in the United States. Together they account for approximately 85 percent of U.S. industrial output and more than 80 percent of U.S. industrial employment.

I appreciate the opportunity to testify at these hearings and wish to commend the committee for identifying the critical relationship between the exchange rate system and the trading system for study.

Much has been said and written over the past few months regarding last year's unprecedented $123 billion U.S. trade deficit and its relationship -- both cause and effect -- to this country's economic competitiveness. Today, I want to focus particularly on the key aspect of the trade deficit and the competitiveness problem, namely the interrelationship with the overvalued dollar.

It is universally conceded that the high dollar is now the principal cause of the continuing increase in the trade deficit, as well as the competitive problem U.S. industry is facing in both domestic and foreign markets. U.S. Trade Representative William E. Brock recently stated before a group of American and foreign industrial leaders that he estimates that the high value of the dollar accounts for 80 percent of the current trade deficit. Whatever we do to resolve our competitive difficulties, nothing will work unless and until we have success in dealing with the overvalued dollar. To quote from the late Otto Eckstein, in a report on U.S. manufacturing industry competitiveness published last year by Data Resources Inc.:

> No degree of cleverness on the part of management, no new-found cooperation between employees and workers, no industrial policies by the federal government can overcome the burden of an overvalued dollar and a domestic economy dissipated by credit crunches and recession every three or four years.

The Trade Deficit and the High Dollar: Scope and Consequences of the Problem

I start with the premise that the trade deficit is terribly serious, is undermining the industrial base of the nation, and ultimately if left unattended will lead to protectionist "solutions" that will have grave consequences for this country and our friends and allies abroad. The problems which created a $123 billion overall trade deficit in 1984 and a manufactures trade deficit of almost $90 billion ($50 billion higher than in the previous year) are long-term, not short-term. This includes notably the misalignment of the U.S. dollar against all major currencies.

This year's Economic Report of the President noted that by the end of 1984, the exchange value of the dollar, as measured against the currencies of the world's ten other leading industrial nations, was 65 percent higher than in 1980. This is the fifth year of the high dollar. This situation has persisted despite U.S. trade and current account deficits on an unprecedented scale and many predictions of a rapid fall in recent years -- and despite the fact that the basic premise of the floating rate system is that large current account deficits will lead to an automatic and self-correcting fall in the value of a country's currency.

Furthermore, let me state at the outset that I do not subscribe to the pollyanna view that the high dollar brings benefits to our economy which outweigh the negative impact on U.S. trade. It may be true, that by making imports cheaper the high value of the dollar has helped hold down inflation during the present economic expansion. But record-breaking levels of imports and high domestic interest rates, while they may keep inflation under control, are transforming the economic structure of this country. Initially, these changes were not readily apparent because of the general effects of rapid growth. But the slowing of growth over the last three quarters plus the generally unexpected continuation of the dollar's rise in 1984 and early 1985 have brought about greater recognition of the widespread and permanent damage that has occurred to the U.S. industrial base. Additionally, the negative effects on agriculture and mining are of major importance.

Let's look first at trade in major manufactured goods sectors. This country has essentially lost its edge in high technology and capital goods. As recently as 1981, the U.S. had a surplus in manufactured goods trade. The first large chart that I have here, global trade balances in manufactured goods (Exhibit 1), indicates how the U.S. surplus has fallen by nearly $100 billion in just four years, while our major competitors, the Japanese and the Germans, have expanded or maintained their surpluses. In contrast with a U.S. manufactured goods deficit of $90 billion last year, Japan had a global surplus of over $120 billion and Germany of $60 billion. As shown in the chart in the appendix on sectoral trade balances in manufactures (Exhibit 3), our $46 billion surplus in capital goods in 1981 more than offset the deficits in consumer goods and automotive trade. But last year, our surplus in capital goods was down to just $12 billion, while the deficits in consumer and automotive products totalled $80 billion. This year, Commerce Department chief economist Robert Ortner has predicted an actual U.S. deficit in capital goods. Looking at a different type of measurement, we see on the same chart in Exhibit 3 that our trade surplus in high technology products fell from a high of $29 billion in 1981 to about $9 billion last year. The details of this trade performance, Mr. Chairman, are contained in the trade competitiveness analysis published by our report Trade & Industry on January 18, which I am also submitting for the record.

The high dollar, Mr. Chairman, exaggerates the impact of adverse trade swings on the most competitive sectors of the economy. Let me cite some numbers to back this up. A recent article by senior international economist David Lund for the Commerce Department publication Business America compared import penetration ratios for non-automotive consumer durables and capital goods between 1970 and 1984. In 1970, about 8 percent of our capital goods and 10 percent of our consumer durables were imported. Both numbers increased steadily over the following decade -- by 1980, capital goods imports were 16 percent of the market, compared to 13 percent for consumer goods. The subsequent rise in the dollar has accelerated the rise in imports' real market share, but in capital goods where the U.S. has seen its strongest domestic growth due partly to tax law changes, the real import share is now nearly 26 percent compared to just 17 percent in consumer goods. And some other estimates indicate that capital goods imports may be more in the 30-40 percent range of total consumption.

My conclusion is that under the conditions of rapid import growth, cost-conscious capital equipment renewal and an overvalued dollar, it is in our most competitive capital equipment and high technology industries that we have see the greatest erosion of our competitiveness. By contrast, the rise of import penetration numbers in industries already troubled by import competition before the last recession -- such as cars, steel and textiles, is not so steep, due in part to quota systems which have already been in place.

Finally, it is clear that these developments are having an impact on the dynamics of an overall recovery. Exports did recover by 9 percent in 1984 over 1983, but were still lower by $16 billion than in 1981. Import growth overwhelmed exports, increasing by 27 percent overall in 1984 -- and 36 percent in manufactured goods. It is not surprising therefore that factory orders, industrial production and manufacturing employment have all fallen or slowed dramatically in growth since mid-1984. Moreover, capacity utilization, which normally peaks near 90 percent in a boom year, in this growth period has apparently topped out at around 82 percent, according to statistics in the Annual Report of the Council of Economic Advisors. Part of this could be due to the transfer of production to lower cost, excess capacity or new facilities abroad. We do know, of course, that the latest Commerce Department estimates of planned capital expenditures for U.S. affiliates abroad show a planned 22 percent increase in manufacturing investment for 1985, compared to four percent for 1984 and declines in 1982-93.

"Benign Neglect" Will Not Solve the Problem in the Current Account

There is an argument that the rising dollar and the growing trade deficit reflect an evolution of the U.S. role in the world economy that it would be unwise to try to stop. As the dollar rises due to strong capital inflows -- instead of falling due to the trade and current account deficits -- the U.S. role in the world economy will become less a supplier and exporter of manufactured goods and increasingly a provider of services. However, this chart on the U.S. balance of payments and the trade balance (which is labeled

Exhibit 2 in your packet) indicates that this viewpoint, which I would label "benign neglect," is very dangerous.

For the past decade, the non-merchandise trade factors in our overall balance of payments have substantially buffered or reduced the impact of regular large trade deficits. Since 1976 the overall balance on current account has usually been $20-30 billion more favorable for the U.S. than the trade deficit, as measured on a balance of payments basis. Often, the net result was a positive current account balance despite the trade deficit. The most significant feature of the 1984 numbers is that we have lost this cushion. Due to substantial falls in our net earnings on investments and services, the total current account deficit was almost as large as the deficit in goods trade alone -- $102 billion against $107 billion, if the latter is measured on a "balance of payments" basis.

The $100 billion-plus 1984 current account deficit together with a deficit of over $40 billion in 1983 have created a requirement for nearly $150 billion in net foreign capital account inflows and most predictions are for an even greater current account deficit this year. Normally, a country's currency exchange rate declines in this situation, thereby reducing imports, boosting exports and narrowing the current account gap. The reverse reaction in the U.S. case has stimulated even larger current account deficits and net capital inflows. Our net positive world investment position, built up since the First World War largely by our private banking and industrial sectors, has now turned into a net debtor position.

To a great extent, this change has been accommodated by the ending of American bank loans abroad -- down from $111 billion in 1982 to a net of just seven billion dollars last year. However, new private capital inflows have continued at a rate of $80-100 billion annually in each of the past four years, to which must be added a "statistical discrepancy" that consists mainly of unrecorded capital inflows and that was $30 billion in 1984. An increasing share of all these capital inflows is going directly into buying government debt issues. Moreover, former Council of Economic Advisers Chairman, Martin Feldstein, has made the point that all capital inflows help support the federal budget deficit burden because they contribute to the national capital pool. These inflows reduce the capital available to stimulate domestic investment and growth in our trading partners, especially the less developed countries. They also create a rising interest repayment burden which will make it difficult to balance against the current account.

In stark terms, the private sector has been losing earnings in trade and in foreign investment income due in large part to the high dollar, causing the huge current deficit. The Government is compounding the problem further by financing an increasing part of the federal budget deficit (directly and indirectly) by borrowing foreign capital. Ultimately this debt to foreigners has to be serviced by interest payments and in part paid back. Note this figure: in 1984 the government paid $19 billion in interest to foreigners holding federal debt.

To offset these payments in the current account, we must improve our trade performance. The best way to do this, without adopting restrictive measures to hold down imports, is to seek, in cooperation with other major industrial country governments, ways in which to insure that the dollar's exchange value will reflect more accurately the international competitive position of U.S. industry, agriculture, and mining as indicated by the balance of payments on current account.

NAM Program to Deal with the Overvalued Dollar

In February 1984, Mr. Chairman, the NAM Board of Directors unanimously passed a resolution expressing its concern with the impact of the high dollar exchange rate on U.S. trade performance and proposing a comprehensive program to deal with this problem. Recently the State Department requested comments from NAM regarding the continued high value of the dollar and the policy changes which might be necessary to make the dollar more reflective of the international competitive position of U.S. industry. This request was related to planning for the forthcoming Bonn Economic Summit. Unfortunately, relatively little of the program recommended by NAM's Board last year has yet been implemented. Our response to the State Department has focused on how the steps recommended last year might be updated and implemented to provide a program that we believe the U.S. government should carry to the Bonn Summit in May. I would like to ask that both the 1984 NAM Board Resolution (Exhibit 5) and a statement which summarizes our response to the State Department's request this year (Exhibit 6), be added to the record of my testimony.

Since I am including these statements in their entirety, I will only summarize our program here.

First, I want to relate our program to the causes of the high value of the dollar. A combination of several different factors have caused the high dollar and these factors have changed in relative weight during the past four and one-half years. While the rise of the dollar actually began in an environment of relatively poor U.S. economic growth, followed by a deep recession, there is now a worldwide perception of the strength of the U.S. economy and the relatively poorer economic performance of most the rest of the world. High real interest rates in the U.S. relative to other countries have obviously been very important in attracting capital inflows, regardless of the weight one gives the federal budget deficit as a major cause of high interest rates. Finally, no one wants to cure the dollar exchange rate problem by inducing inflation at home or a recession in the domestic economy.

Our first major step should be to reduce significantly the U.S. federal budget deficit. There is a possibility, of course, that the dollar might temporarily rise even further if we achieve action on the deficit. This risk is offset by the obvious benefits of deficit reduction. It will be very difficult or perhaps impossible to establish a general pattern of growth worldwide and lower interest rates unless the U.S. budget deficit is reduced.

Second, we should encourage policies conducive to sustained growth in Europe and the less-developed countries, especially Latin America. Historically, these countries are among our leading export markets. Our exports cannot grow in a vacuum, and only widespread global recovery can establish the conditions necessary for a robust recovery in U.S. manufactures export growth, whatever the exchange rate of the dollar.

Third, we must undertake steps immediately in cooperation with the central banks and finance ministries of other countries to help assure that the dollar is heading in the right direction on world exchange markets while improving the operation of the present floating exchange rate "non-system." The best approach is to begin with the objective of capping the dollar. The fact that the dollar is down from its recent peak makes such an approach particularly feasible at this time.

This step of capping the dollar could best be done in conjunction with achievement of a successful U.S. budget deficit cut of $50-60 billion, but technical work should be started by central banks without delay. Possibly, we should avoid announcements of currency actions, to lessen the risk of excessive expectations or early failures. In any case, currency markets have to be convinced that the U.S. has made a major policy decision to assert the importance of its national interest in trade. The world trade community will see U.S. exchange rate action as a major step to help stop the spread of protectionism and to move toward more open international markets for goods and services.

In effect, the U.S. has already agreed to such cooperation at the Williamsburg Economic Summit in 1983 and again in the January 17, 1985 "G-5" statement, but U.S. leadership or participation has been sporadic despite these agreements. Perhaps last week's agreement in Paris at the Ministerial meeting of the

OECD (Organization for Economic Cooperation and Development) is evidence of a turning point regarding the U.S. Government's viewpoint on the exchange rate.

The purpose of NAM's program of cooperation in exchange markets is not to overwhelm the markets, but to play a strategic game in cooperation with other countries. Currency markets should know that the U.S. has an "official view," even if unstated, as to the value of its currency, and an exchange rate policy to back this up. Regarding the view that currency markets are too big to be influenced without massive intervention, it has recently been estimated that true long-term flows on exchange markets are less than $500 million per day. This means that calculated, coordinated moves by central banks may have much more impact than commonly believed.

Fourth, the U.S. should initiate consultations leading toward longer term reform of the floating exchange rate system. This longer term effort will help reinforce the short-term efforts described above. It will give credence to the view that the U.S. is serious about adding exchange rate policy to fiscal policy and monetary policy as macro-policy elements. In such discussions, we should not be too dogmatic about what conclusions we will reach, although any consideration of a return to fixed exchange rates or generalized capital controls should be discounted from the outset.

Fifth and finally, no program to improve the operation of the international exchange rate system will fully succeed without the incorporation of the yen as a true international currency. We must therefore speed up the internationalization of the yen. The

U.S.-Japan financial agreement of May 1984 provides the basis for more decisive action by Japan. Especially needed is prompt action to free up domestic financial markets in Japan. The Japanese government should also create the necessary financial instruments (e.g. Treasury bills) so that foreigners can use Japanese financial markets as freely as Japan uses the financial markets in New York, London, Frankfurt and Zurich.

Other Measures to Improve U.S. Trade Performance and Industrial Competitiveness

In this testimony and in other forums I have insisted that no positive measures to reverse the U.S. trade deficit are likely to work satisfactorily without an effective program to readjust the dollar exchange rate. But that does not mean we can ignore these other measures. Far from it -- the U.S. trade deficit has assumed such large proportions that it is essential that the Administration and the Congress take a number of other major measures to address trade problems. Potentially, the most important of these measures are the following:

- Eliminate the barriers to U.S. exports that we ourselves have erected. For example, the President's Commission on Industrial Competitiveness has estimated that foreign policy and national security controls now annually cost the U.S. over $12 billion in lost export sales. We urge Congress to pass H.R. 28, the export control reform bill now moving through the House, as a major step toward overhaul of our export controls.
- Improve U.S. access to foreign markets through direct negotiations with our trading partners, notably Japan.
- Improve the international trading system. We strongly support the President's call for a new round of multilateral trade negotiations. In our view, a new GATT round should at least aim to achieve: discipline over national industrial policies that distort trade

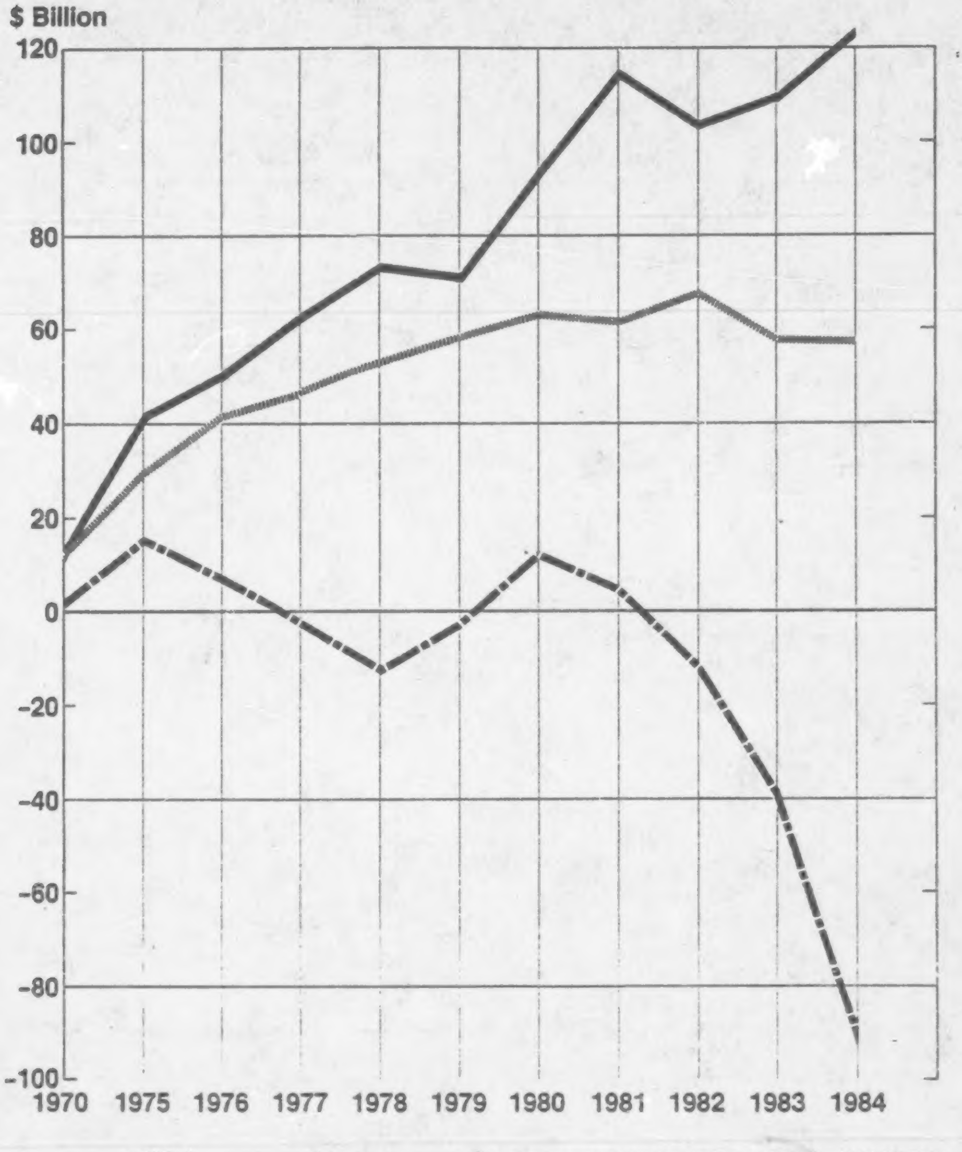
flows; a better dispute settlement mechanism; a transparent "safeguards" code to deal with sectoral trade restrictions; improved Government Procurement and Technical Standards Codes; more effective redress of counterfeiting violations with generally better protection for intellectual property; and a meaningful set of rules for trade in services.

- Indicate our determination to be competitive and to insist on fair and equal treatment for U.S. manufacturers as well as our trading partners. The former purpose can be signally achieved by making Eximbank an effective and competitive vehicle for export finance -- which it is not at present. The latter especially relates to more vigorous enforcement of U.S. trade laws, as has long been advocated by NAM.
- Finally, the U.S. must take the steps in our internal economy that truly make a country competitive -- adopt measures in the field of taxation, R and D, education, fair trade and competition laws -- all in the context of a U.S. that must live and prosper in a world competitive environment. The Young Commission on Industrial Competitiveness has identified the major areas requiring attention.

In closing Mr. Chairman, I want to state that I can think of no more timely or appropriate subject for Congress to review at present than our trade deficit and the implications for U.S. competitiveness. We are at an economic crossroads. We must bring under control the massive twin deficits -- the trade deficit and the federal budget deficit -- which continue to bedevil our economy. Otherwise, continued recovery in the U.S. domestic economic growth will prove to be unsustainable, with resultant bad news for the world economy.

EXHIBIT 1

CHART 1: Trade Balances in Manufactured Goods

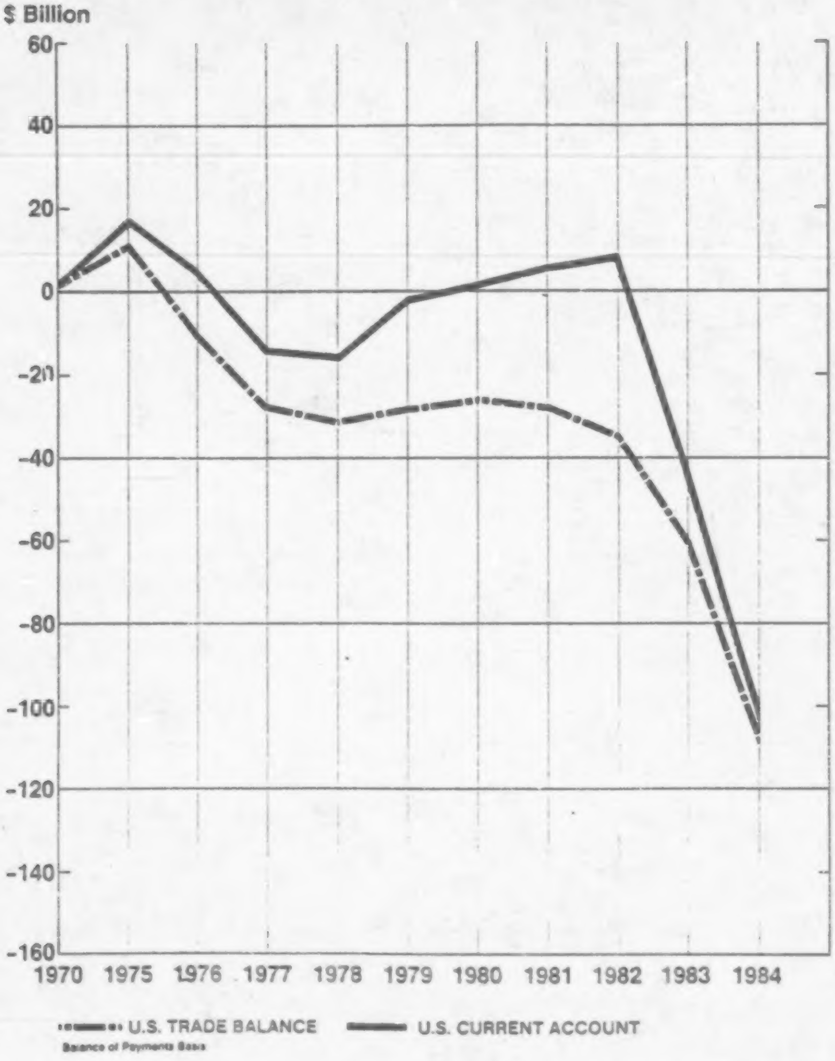


Japan and Germany: January–June 1984 at annual rate.

PREPARED BY THE NATIONAL ASSOCIATION
OF MANUFACTURERS 4/10/85

EXHIBIT 2

CHART 2: U.S. Trade Balance and U.S. Balance of Payments on Current Account

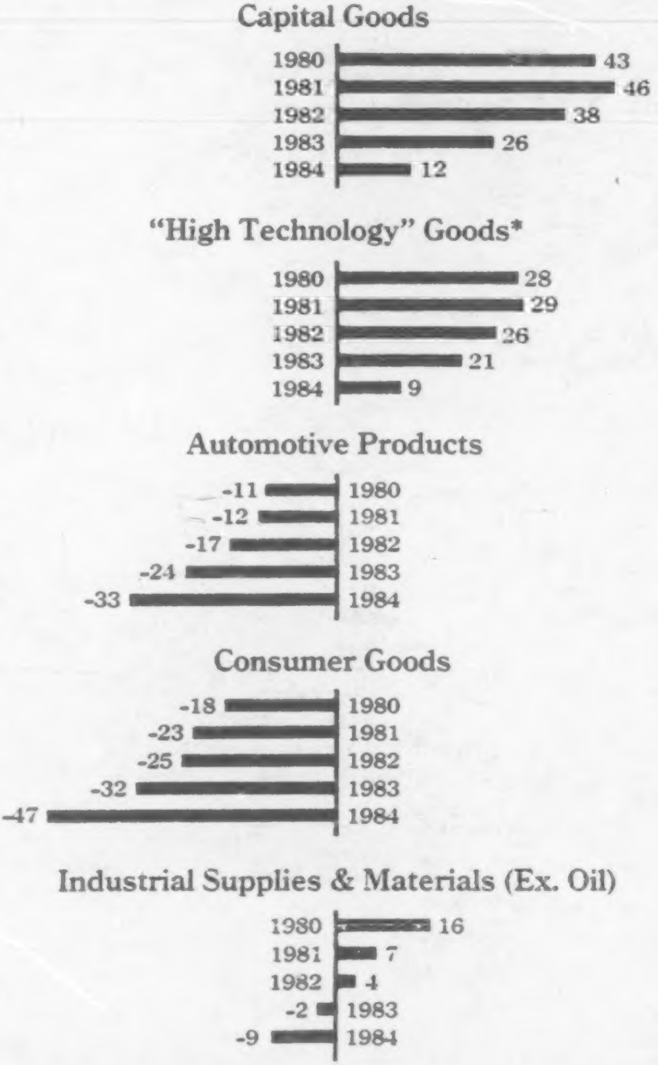


PREPARED BY THE NATIONAL ASSOCIATION OF MANUFACTURERS
4/10/85

EXHIBIT 3

Major Sectoral Balances in U.S. Manufactures Trade

(All Figures in $U.S. Billions–Imports f.a.s. or customs value)

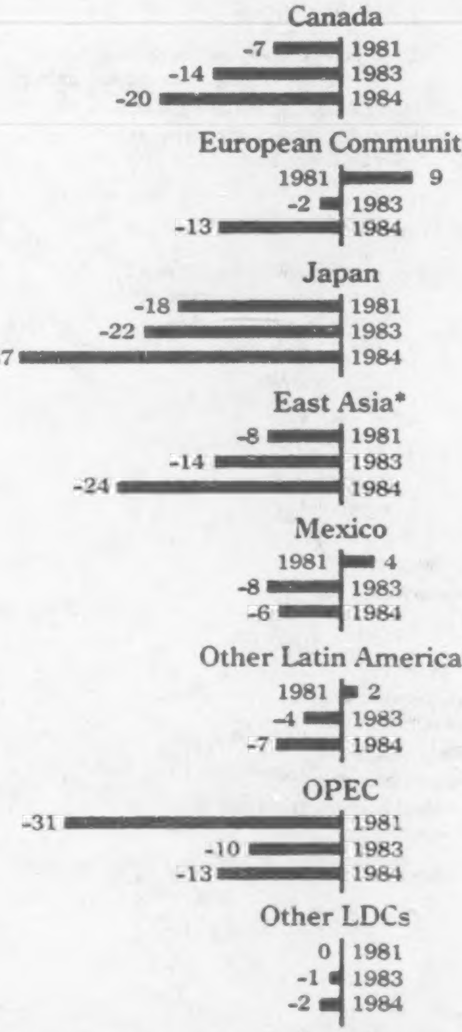


*High technology goods as defined by Commerce Department, definition no. 3.
Source: NAM, from Commerce Department statistics.

EXHIBIT 4

U.S. Trade Balances With Major Trading Partners

All Figures in $U.S. Billions-Imports c.i.f.



*Excluding Indonesia, which is counted with OPEC.
**Excluding Venezuela and Ecuador, which are counted with OPEC.
Source: NAM, from Commerce Department statistics

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EXHIBIT 5

ADOPTED BY, NAM BOARD OF DIRECTORS
FEBRUARY 10, 1984

RESOLUTION ON THE EXCHANGE RATE FOR THE U.S. DOLLAR

Whereas a competitive U.S. industrial base is possible only if the exchange rate for the dollar is realistic relative to the currencies of other major trading countries;

Whereas exchange rate policy must be developed within the context of national economic policy, and macroeconomic policies must be shaped with due regard for direct and indirect impact on exchange rates and trade;

Whereas the substantial rise in the value of the dollar against the yen, the deutsche mark and other major industrial country currencies in recent years has more than offset the reduction in the U.S. inflation rate and efforts to improve industrial productivity, thus making American-produced goods less competitive in both domestic and world markets;

Whereas the reduction in U.S. price and cost competitiveness due to exchange rate changes alone has been calculated as costing more than one million jobs in the domestic U.S. economy and has contributed significantly to the 1983 record U.S. trade deficit of $70 billion;

Whereas the effects of the dollar exchange rate misalignment are most serious respecting the yen and the deutsche mark, the currencies of our principal industrial competitors, and have contributed to their very large manufactured goods trade surpluses, as well as to the huge and growing U.S. trade deficit;

Whereas the deterioration of the U.S. trade and current account balances since 1980 has not led to a counter-balancing reduction in the exchange value of the dollar, but rather the dollar has maintained its value or even strengthened significantly against all major foreign currencies;

THEREFORE BE IT RESOLVED that the National Association of Manufacturers recommends that the U.S. develop fiscal and monetary policies designed to achieve progressive elimination of the federal budget deficit and reduction of high U.S. interest rates, and thereby help the dollar reach and maintain an exchange rate appropriate to the U.S. competitive position, while achieving major domestic macroeconomic goals.

BE IT FURTHER RESOLVED that the National Association of Manufacturers urges the development of an explicit U.S. exchange rate policy supportive of U.S. trade performance. Such an exchange rate policy should include:

- Improved coordination and consultation with other countries regarding the international effects of domestic economic policy, with the purpose of reducing dollar exchange rate misalignment, in accordance with agreements reached at the 1983 Williamsburg economic summit;
- Improvement of the present exchange rate system through the introduction of a greater degree of structure, the purpose being to reduce the present dollar misalignment without excessive levels of government intervention in currency markets;

(OVER)

- Special attention to the international position of the Japanese yen, to encourage its greater use as an international transaction and reserve currency, and thereby to encourage greater international demand for the yen relative to the dollar — thus raising its value. The recent agreement of President Reagan and Prime Minister Nakasone is an important step in the right direction and should be fully implemented as soon as possible.

In addition, the U.S. should take the lead in seeking long-term improvement in the international exchange rate system. Consultations with Germany, Japan, other major industrial countries and the IMF to reform the present system should be undertaken, so that it can better achieve the original objective of facilitating trade and investment by reflecting changes in economic fundamentals which determine competitiveness.

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EXHIBIT 6

APRIL 10, 1985

NAM Statement on U.S. Dollar Exchange Rate

On February 10, 1984, the NAM Board of Directors unanimously adopted a resolution on the dollar exchange rate and U.S. competitiveness. This resolution emphasized the negative impact of the rising dollar on the U.S. trade and current account balances, the U.S. industrial base, and the structure of the U.S. economy. Corrective policy actions by the U.S. government were recommended.

Over the past year there has been further deterioration in this situation. According to the 1985 Economic Report of the President's Council of Economic Advisors, by the end of 1984 the U.S. dollar exchange rate, as measured against a weighted basket of industrial country currencies, was 65 percent higher than in 1980. This was the highest exchange value that the dollar had reached since flexible exchange rates were introduced in 1973. At the same time, the U.S. merchandise trade deficit has dramatically worsened to almost $125 billion in 1984, and it is universally accepted that the persistent strengthening of the dollar is the major cause. The trade balance in manufactured goods deteriorated by about $50 billion in 1984.

Furthermore, the Department of Commerce has just reported that the overall deficit in the balance of payments on current account for 1984 had grown by over $60 billion last year, to $102 billion. Unlike the 1970s and the early 1980s, our growing trade deficit is no longer offset by increased net earnings in the other international transactions, such as private sector earnings on investments and the sale of services. Virtually all of 1984's trade deficit has been financed by an increase in the net public and private indebtedness of the United States to foreigners. This indebtedness and related interest payments will ultimately have to be serviced or repaid through increased current account earnings -- that is, through improved U.S. trade performance.

Recently the State Department requested comments from NAM regarding the continued high value of the dollar and the policy changes which might be necessary to make the dollar more reflective of the international competitive position of U.S. industry. This request was related to planning for the forthcoming Economic Summit. Unfortunately, relatively little of the program recommended by NAM's Board last year has been implemented. Our response to the State Depatment and this statement, therefore, focus on how the steps recommended last year might be updated and implemented to provide a program that the U.S. government should carry to the Bonn summit in May.

A combination of several different factors have caused the high dollar. These factors are well known and have been widely discussed, but they have changed in relative weight during the past four and one-half years of the high dollar. While the rise of the dollar actually began in an environment of relatively poor U.S. economic growth, followed by a deep recession, there is now a worldwide perception of the strength of the U.S. economy and the relatively poorer economic performance of most the rest of the world. High real interest rates in the U.S. relative to other countries have obviously been very important in attracting capital inflows, regardless of the weight one gives the federal budget deficit as a major cause of high interest rates. Naturally, no one wants to cure the dollar exchange rate problem by inducing inflation at home or a recession in the domestic economy. The problem of continued dependence of foreign economic recovery on ever greater exports to the U.S. market, with the resultant large and still growing U.S. trade and current account deficits, is an issue which should be discussed at the Economic Summit.

Therefore, the Economic Summit should address the dollar exchange rate problem, as well as the necessary steps to begin to put into place an improved exchange rate system that will more realistically represent U.S. trade considerations. The following are the essential steps needed to deal with the problem:

1. Significantly reduce the U.S. federal budget deficit. There is a possibility, of course, that the dollar might temporarily rise even further if we achieve action on the deficit. This risk is offset by the obvious benefits of deficit reduction. It will be very difficult or perhaps impossible to establish a general pattern of growth worldwide and lower interest rates unless the U.S. budget deficit is reduced.

2. Encourage policies conducive to sustained growth in Europe and the less-developed countries, especially Latin America, which are historically among our leading export markets.

3. Speed up the internationalization of the yen. The U.S.-Japan financial agreement of May 1984 provides the basis for more decisive action by Japan. Especially needed is prompt action to free up domestic financial markets in Japan. The Japanese government should also create the necessary financial instruments (e.g. Treasury bills) so that foreigners can use Japanese financial markets as freely as Japan uses the financial markets in New York, London, Frankfurt and Zurich.

4. Take steps to decrease worldwide use of the dollar as a "convenience" transaction currency, not by restrictive measures but by positive encouragement to use the yen, mark and other currencies more extensively in commercial transactions and central bank reserves. For example, it may be possible and desirable for the European Community to reduce use of the dollar in transactions related to managing their currency "snake."

5. The Treasury should explore, in consultation with other countries, the possible advantages of issuing U.S. federal debt issues in currencies other than dollars.

6. Take concrete steps in cooperation with the other major industrial countries to improve the operation of the present floating exchange rate non-system. In effect, this was agreed at Williamsburg in 1983 and expressed again in the January 17, 1985 "G-5" statement, but U.S. cooperation and participation has been sporadic at best. A more substantial commitment would require that the U.S. establish a stock of foreign currencies, which could be based on existing swap agreements.

   The purpose is not to overwhelm the markets, but to play a strategic game in cooperation with other countries. Currency markets should know that the U.S. has an "official view," even if unstated, as to the value of its currency, and an exchange rate policy to back this up. Regarding the view that currency markets are too big to be influenced without massive intervention, it has recently been estimated that true long-term flows on exchange markets are less than $500 million per day. This means that calculated, coordinated moves by central banks may have much more impact than commonly believed.

7. The best approach to the previous step is to begin with the objective of capping the dollar. This could best be done in conjunction with achievement of a successful U.S. budget deficit cut of $50-60 billion, but technical work should be started by central banks without delay. Possibly, we should avoid announcements of currency actions, to lessen the risk of excessive expectations or early failures.

   Currency markets have to be convinced that the U.S. has made a major policy decision to assert the importance of its national interest in trade in manufactured goods, agricultural products, coal and other minerals. The world trade community will see U.S. action as a means to help stop the spread of protectionism and to move toward more open international markets for goods and services.

8. Start consultations leading toward longer term reform of the floating exchange rate system. An appropriate technical forum, such as the IMF's C-20, G-5 or the Bank for International Settlements in Basel might be chosen. This longer term effort will help reinforce the short-term efforts described above. It will give credence to the view that the U.S. is serious about adding exchange rate policy to fiscal policy and monetary policy as macro-policy elements.

   As we begin such discussions, we should not be too dogmatic about what conclusions we will reach, although any consideration of a return to fixed exchange rates or generalized capital controls should be discounted from the outset. These consultations should be guided by our continuing short-term experience in capping the dollar. Above all, the U.S. must work in cooperation with the other major actors in the international financial system, whose fundamental interests in a sound international exchange rate system are not different from our own.

9. The program outlined above will help do one more thing: it will prolong the U.S. economic recovery by helping to convince the world that the U.S. means to deal with its $100 billion current account deficit and its consequent status as the country with the fastest and most significant increase in foreign debt. The sooner we do this, the more likely the Europeans as well as others will begin to take responsibility for promoting their own growth by means other than exports to the U.S. market and to former U.S. markets, where their products are now unduly competitive because of the high dollar. This is another important message for the Bonn Summit.

STATEMENT OF RUDOLPH OSWALD, DIRECTOR, ECONOMIC RESEARCH DEPARTMENT, AFL-CIO, WASHINGTON, DC

The CHAIRMAN. Mr. Oswald.

Mr. OSWALD. Mr. Chairman, I thank you for the opportunity to present the views of the AFL-CIO before this committee.

There is one element in the exchange rate that in your earlier discussion, I believe, has not been highlighted, and that is the effect of the growing dollar against other currencies on U.S. workers.

The estimates are that there are 2 to 3 million workers who have lost their jobs as a result of the very high dollar and the strength of that dollar. But I would also like to put it in a different context. We often speak of the dollar having increased 70, 80 percent since mid-1980. But it isn't that it has taken one big jump. The increase has been about 15 percent a year.

And each year, we have been told that it's reached its zenith and it's going to start going down. Well, a year ago, there were some early movements with the dollar initially going down, and then as the year progressed, it went up another 15 percent.

Well, initially, there had been very strong attempts by workers who are making a strong means of trying to adjust to those sorts of changes. There were substantial increases in productivity. There have been substantial reductions in a number of industries in the wages that workers earn in order to be as competitive as they were back in 1980.

But there is no way that workers or that firms can make adjustments in their total costs—material costs, labor costs, costs of capital, costs of utilities—to offset what has now become a 70- to 80-percent swing in the value of the dollar.

And the results are, not only today but in the months to come, that the situation will get worse because the normal rule of thumb is that the exchange rate has an effect for the next 18 months before it is fully felt.

So that there will be continual job losses. And unless something is done rapidly to make a change, we will not have the ability to protect those jobs and those industries that are being lost.

The first thing that we have recommended is that there is already an effect that says that the President can impose a 15-percent surcharge or quota to prevent the disruptions that come. He hasn't done that. And I think it should be done. It would not be—doing that would bring about retaliation. It's time for the United States to retaliate against the loss of jobs that comes about from this distortion of the exchange rate.

Everyone understands and admits that we've had a substantial distortion, and it's time to put that—to correct it. If the President doesn't act, we believe that the Congress should direct him to act as the law provides.

We agree with Mr. Fox's and NAM's proposal in terms of improvements, in terms of negotiating international elements to bring down—coordinate to bring down—better intervention to bring down the exchange rate. And we think improvements need to be made in the U.S. trade laws by adjusting the current injury remedy procedures and for the unfair trade practice laws that could be improved to take care of some of the other trade problems as they are related thereto.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Oswald follows:]

85-15

**Testimony of Rudolph A. Oswald, Director, Department of Economic Research,
American Federation of Labor and Congress of Industrial Organizations
on Floating Exchange Rates' Impact on International Trading
Before the Committee on Finance, United States Senate
April 24, 1985**

SUMMARY

The monetary and fiscal policies that have been pursued by our government for the last several years produced high interest rates, a vast inflow of foreign capital, and a dollar exchange rate value which was greatly increased in relation to the value of other major currencies. The overvalued dollar was a significant element in producing an increased, abnormally high deficit trade balance, which reached $123 billion in 1984. Over 70 percent of this negative trade balance was in manufacturing. The trade imbalance has cost the United States between 2 and 3 million jobs.

To overcome the misalignment of exchange rates and the great trade imbalance that it produces in the world, an international forum should be established in which the major industrial nation's can negotiate and make corrective adjustments as necessary. The forum would also serve for explorations of variations in the present exchange rate system designed to bring about greater stability. To provide some immediate relief, the Congress should act to have the President implement Section 122 of the Trade Act of 1974 and impose a temporary 15 percent import surcharge. There is a need to regain lost revenue so that tne budget deficit can be reduced; and appropriate steps should be taken toward that end, by closing loopholes which benefit primarily business and wealthy individuals. U.S. trade laws must be strengthened to alleviate trade induced injury, and there should be more effective remedies against unfair trade. Special legislation is needed to deal with specific industry problems.

85-15

**Testimony of Rudolph A. Oswald, Director, Department of Economic Research,
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on Floating Exchange Rates' Impact on International Trading
Before the Committee on Finance, United States Senate
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On behalf of the AFL-CIO, I wish to convey our thanks to you for holding this hearing; it is definitely needed.

Until a few weeks ago, the U.S. dollar seemed to defy the law of gravity. Since it took off in mid-1980, the dollar has been on a long-term upward spiral. The peak was reached in February 1985 when its value, compared with the value of currencies of 10 other major industrialized trading nations, had increased 87 percent from its mid-1980 level. This increasing value of the dollar contributed significantly to increases in the United States' merchandise trade deficit, along with export subsidies, tariff and non-tariff barriers to imports, dumping and other unfair trade practices. From a deficit level of about $25 billion in 1980, it rose in succeeding years to $28 billion, $36 billion, $69 billion, and $123 billion in 1984 and is still rising. The very punishing growing merchandise trade deficit has impacted upon our economy and has cost the equivalent of 2 to 3 million jobs.

In its February 1985 statement on the Trade Deficit, the AFL-CIO Executive Council pointed out that $89 billion of the $123 billion overall trade deficit in 1984 was in manufactured goods and called for more effective relief to injured industries and their workers. A copy of the Council statement is appended. The adverse effects of the trade crisis, which is dragging our economic growth to a halt is being felt in a great variety of production activities. That is borne out by the import penetration of U.S. markets. Thus, in 1984, the penetration ratios were 17 percent for computing equipment; 31 percent for metal cutting machine tools; 34

percent for semi-conductors; 48 percent for motorcycles, bicycles, and parts; 75 percent for fine earthenware; 78 percent for womens handbags, and purses; and significant ratios for many other product lines.

The 1984 negative balance was accumulated through trade in various countries and regions of the world. The largest component of the negative trade balance was $37 billion with Japan. Others were $20 billion with Canada; $17 billion with western Europe, including almost $9 billion with Germany; $11 billion with Taiwan; and $8 billion with Mexico. The 1984 drop-off in American exports and increase of imports in such product lines was due in large measure to the overvalued dollar which during 1984 had an average exchange rate value that had risen 58 percent above the average value for 10 other major currencies since 1980. That means that American costs needed to be 58 percent lower in 1984 than in 1980 in order to be at the same competitive position that they held just four years earlier. Material, capital and labor costs would all need to be lowered by 58 percent to achieve in 1984 the same competitive position that American industry had in 1980. Thus, American workers would need to either be 58 percent more productive — or take a 58 percent wage cut. To us in the labor movement, it is not right to expect workers to take a 58 percent wage cut to offset the effects of the fiscal and monetary policies pursued by the government. These were major elements in causing the rise in the dollar. The competitiveness of American workers is not impaired because their wages increased, but rather because the dollar rose in value. Workers are paying for this policy by losing their jobs to imports and being forced out of the export market.

In the last three years, the U.S. also began to run a deficit balance on its current account, as the net investment income received by U.S. residents declined, because there had been a large influx of foreign investments on which interest and dividends were paid. The net investment income received by U.S. residents became too small to outweigh the negative trade balance.

There were foreign capital investments in U.S. government and private securities, and in whole or share equity ownership of businesses. To make the dollar denominated investments, foreigners had to acquire dollars in exchange for foreign currencies, which kept the value of the dollar high. In fact, the dollar kept rising in value despite the large negative merchandise trade balance and the negative balance on current account. Instead of leading to a reduction in the value of the dollar, the trade deficits were offset by the capital inflows. The inflows also eased the financing of the federal budget deficits.

High interest rates were the great attraction for the foreign investments and thus contributed substantially to U.S. dollar overvaluation. The capital outflows from other major industrial countries slowed down their economic growth and demand for American products.

Back in 1980-81, most of the leading industrialized countries in the world shared with the United States the experience of very high interest rates in response to inflation and tight monetary policies designed to combat inflation. Japan, with the help of capital and credit market controls, was the first to bring interest rates down significantly, in the latter part of 1980. Germany brought its rates down in 1981. Both of the latter countries established interest rates well below those of the United States for comparable maturities. The United Kingdom and France took longer, but in 1983-84 they also had interest rate levels below those of the United States. In Canada, the interest rate movements were fairly similar to those of the United States.

The U.S. dollar remained sufficiently "overvalued," so that many developed and developing countries could enjoy a significant price advantage over the U.S. and a favorable balance with the U.S. in international trade. Japan had the largest favorable trade balance with the United States -- $37 billion -- in 1984 when the exchange rate was 237 yen per dollar. In 1978, when the rate had been 208 yen and at times during the year at 180 yen to the dollar, Japan's favorable trade balance was $11.5 billion. These results also reflect the effect of many Japanese trade barriers.

The relatively higher costs of new plant investments in the United States than in countries whose currency declined in value relative to the dollar also encouraged American firms to build new plants overseas, which meant that the jobs went overseas.

As the U.S. economy showed strong growth during 1983 and 1984, while a relatively tight money policy was pursued, interest rates in this country remained high; and the foreign capital inflow continued. If there was evidence needed that the interest rates were the strategic factor in maintaining the high value of the dollar, it was provided by the economic record of the first quarter of 1985. With the slowdown in the economy to a much slower growth rate, interest rates dropped; and the Federal Reserve Board let nature take its course in a softening economic climate. The exchange rate value of the dollar also declined. Against the German mark, for example, the dollar declined by about 13 percent during the six weeks ending in mid-April. However, that still leaves the exchange rate value of the dollar about 65 percent higher in terms of the mark than it was in 1980.

As a consequence of high U.S. interest rates, developing countries have suffered by having to pay high interest rates on their loans. On the other hand, the resultant high value of the dollar has helped them, as well as major industrial trading partners of the U.S., to sell their exports in the U.S. and elsewhere in competition with U.S. producers. And the U.S. is suffering from a massive, growing negative trade balance, which contributes significantly to an economic slowdown and contraction of the largest market for products from other countries.

The whole quagmire of misaligned exchange rates and abnormal trade imbalance cries out for an international solution. It highlights the contrast between the signficant progress in development of an international economy and the lack of adequate international institutions to address the intertwined exchange rate and trade problems. While the International Monetary Fund is charged with promotion of exchange stability, and exercises "firm surveillance" over the exchange rate policies of its members, it does not provide a forum for negotiations to arrive at an exchange rate alignment that will promote greater balance for international trade and economic growth.

In the absence of institutional innovations to address the international exchange problem, the central bank of each country will continue to devote its paramount concern to domestic economic problems. It will be difficult to achieve a coordination of national monetary policies which is needed to obtain a reasonable equilibrium of exchange rates. To effectively achieve the stated objective, it would require the establishment of an international forum, at least among a few major industrial nations, for continuing negotiation to make adjustments from time to time that would produce an equilibrium of international exchange rates to avoid such a misalignment and huge trade deficits as the United States is presently experiencing. The American economy, and eventually the world economy, cannot continue on a path of stable economic growth with such a trade deficit for the largest economy. Furthermore, experience of the last few years would indicate that the trade deficits, in themselves, will not in this age soon bring about a realignment of exchange rates. Individuals and businesses around the world can take advantage of modern communications for conversion of money from one currency to another and electronic transfers to invest funds in those countries where high yields are available. While such capital inflows to the U.S. have helped to finance the federal budget and international trade deficit, the dollar has remained overvalued, a significant factor in the continued growth of the U.S. trade deficit. The necessary international consultations and negotiations for dealing with periodic realignment of exchange rates might be undertaken under expanded auspices of the IMF, the OECD, or in a special forum created for the purpose.

Such a forum could have several tasks. One would be to prepare for fire fighting actions against speculative attacks on currencies that cause great volatility. An anti-speculation intelligence apparatus and firm commitments for necessary large-scale intervention should be established.

A more important function would be to have under continuous review the interest rates, international capital flows, and exchange rates and their effects upon the national and international economies. Much of the economic data and analytic work produced by the OECD and IMF would be helpful. The objective would be to provide a basis for negotiations for changes to produce greater stability in exchange rates and reasonable international trade balances. There might be some helpful trade-offs negotiated. For example, there might be an agreement for changes in monetary policy to lower interest rates in country A by 2 percentage points if country B would lower its rates by 1 percentage point, looking toward a change in economic growth rates, capital flows, and exchange rates that would reduce a large trade imbalance.

Another subject for study and negotiation would be the matter of possible modifications of the present exchange rate system, which is coordinated within the European community, but not for the rest of the world. There have been suggestions that if deliberate coordination might be undertaken by three leading countries -- the United States, Japan, and Germany -- there could be greater stability in the entire international exchange rate system.

The last two proposed undertakings probably would require many months to come to fruition. The trade problem facing the United States, however, is serious and immediate; and the President should take action to remedy the situation under an existing remedial statute.

The President is directed under Section 122 of the Trade Act of 1974 to take certain actions "whenever fundamental international payments problems require special import measures to restrict imports." These actions are to be taken to deal with large U.S. balance of payments deficits, to prevent an imminent and significant depreciation of the dollar, or to collaborate with other countries in correcting an international balance of payment disequilibrium. The President, under such conditions, may, for a period of up to 150 days, impose a temporary surcharge of up to 15 percent on imported articles, invoke temporary limitations through quotas on imports of articles, or do both. Such temporary actions could and should be used to help alleviate the present trade imbalance. However, the President has not taken any action. The Congress should act to advise the President that, in light of a negative payments balance of over $100 billion last year, reflecting a large and growing trade imbalance, the conditions that require Presidential action under Section 122 of the Trade Act of 1974 now exist; he has not advised the Congress, as required, that the imposition of import restrictions under Section 122(a) would be contrary to the national interest; and he is directed to impose such restrictions.

As has recently been suggested by some European officials, there is a need for international discussions on monetary policy to go on in parallel with and be coordinated with discussions for modified trade agreements. Since the two types of policies necessarily have interacting effects, it is essential that the negotiations on the two policy matters be coordinated. There have been objections to this idea from officials who deal with trade and from some concerned with general economic policies. Their life would become more complicated, but this is a necessity in an international economy that has become more complicated.

There is also a need to regain lost revenues, so that the budget deficit can be reduced, which would also help to reduce interest rates and counteract those developments which have led to an overvalued dollar. In order to convey briefly the AFL-CIO position on taxes, I am reproducing the following paragraphs from a letter of March 14, 1985 from AFL-CIO President Kirkland to Secretary of the Treasury Baker, setting forth the AFL-CIO's position on the Treasury Department's Tax Simplification and Reform Proposals.

> We believe that insofar as the Treasury's recommendations take the poor off the tax rolls and put corporations and wealthy tax avoiders on, they represent a major step in the direction of tax justice; however, among other concerns, we are firmly opposed to the attempts to tax employer-paid benefits such as group life and health insurance, education assistance, prepaid legal assistance and child care, as well as unemployment compensation and workers compensation.
>
> We also believe it would be wrong to eliminate the deductibility of certain state and local taxes. That proposal would severely impair the ability of states and localities to meet their own fiscal needs and would have a particularly severe impact on the more heavily populated industrial states where taxes on personal incomes, homes, and consumer purchases are the major revenue producers.
>
> We are also deeply concerned over the insistance upon "revenue neutrality" as a prerequisite for tax reform. In large part because of the huge and continuing revenue drain of the 1981 Tax Act, the tax structure is incapable of meeting the revenue needs of the nation. The emphasis on revenue neutrality in effect preempts any use of closing tax loopholes in reducing the deficit. We believe this is wrong and that sooner or later legislators will be forced to recapture lost revenues.
>
> We also believe that a major restructuring of the tax system as proposed by the Treasury should also enhance the progressivity of the tax structure. Therefore we question the stress on "neutrality" in terms of the overall distribution of the tax burden. A number of studies have shown that the disparity in income distribution, before and after taxes, has increased in recent years. We believe the Treasury's sights should be set higher than merely preserving the present distribution of the burdens among income classes.

A copy of the entire letter is appended to this testimony statement.

If the foregoing monetary, fiscal, and exchange rate policy remedies are adopted and implemented, more stable exchange rates and increased international trade would be encouraged. This will not happen overnight, however, and a large dollar overvaluation will continue to give foreign producers competitive price advantages ranging between 15 and 50 percent. There are also other factors, stemming from the fact that the United States adheres more to free trade than its trading partners. Most obvious is the growing volume of imports from non-market economies which are the antithesis of free labor and cannot be included as part of a free trade world economy in an accepted meaning of the words. There are many other countries where there are no restrictions against child labor and a lack of regulation to protect the health and safety of workers.

Some of the advanced industrial countries have given producers of export products below-market interest rate financing and have kept foreign competition out of their domestic markets through tariff barriers, restrictive product specifications, inspection slowdowns, and other non-tariff barriers.

With respect to less developed industrializing countries, however, the serious competitive pricing gap, as compared with the U.S. and other advanced industrial countries, will not be closed because of a huge wage gap. In some developing countries wages amount to only a minor fraction of wages paid for comparable work in the United States.

Price competition by U.S. producers to overcome all of the aforementioned unfair trade practices and low labor standards would require such low wages in the United States as to cause a significant reduction in the standard of living and a contraction of the U.S. economy. Letting the low wage and subsidized products of many developing countries into the United States without any restriction would mean increased unemployment. There has been, over about the last 15 years, an upward, long-term trend in the U.S. unemployment rate. That unemployment rate, moving in a pattern generally inverse to the business cycle, has been rising from one peak to the next and from one trough to the next. The resulting long and deep recessions cause a considerable slowdown of economic growth when they occur and also for the future as lost product income, savings, and capital formation retard the economy.

Incidentally, U.S. consumers get a relatively small part of the wage differential advantage, as the foreign producers, exporters, importers, and retailers each take as much advantage to increase their mark-up as the market will permit.

U.S. trade law must be strengthened to reflect international trading realities. It is time to recognize that the principal approach to trade problems taken by the U.S. government -- encouraging other countries to stop what are considered to be objectionable practices -- has failed. Both "fair" trade laws designed to alleviate trade-induced injury and "unfair" trade laws designed to counteract dumping and subsidies should have better procedures and more effective remedies.

The AFL-CIO believes that the help promised to injured industries for 20 years had not become a reality. The safety valve promised to those who are affected by tariff-cutting and import surges, the so-called "escape clause," now Section 201 of the Trade Act of 1974, has never been effective. The escape clause provisions of the Trade Act should be revised to allow quick relief from trade injury.

The 1981-82 worldwide recession experience illustrated the effect of an U.S. economic contraction on other developed and less developed countries. Against this background, the U.S. labor movement has advocated import quotas for various products which would permit a margin of growth for LDCs without overwhelming the U.S. economy. The advocates of pure free trade claim that workers who become unemployed because of imports should go elsewhere to seek work. The thesis has been developed that growth requires both labor and capital resources to be continually reallocated to their most efficient uses. This is even used as a rationale for curtailing unemployment compensation, to remove disincentives for people to move out of declining industries and areas into growing ones. In a more formal statement of the thesis, it has been said that benefits for the unemployed and unions do not allow labor "to clear the market." In other words, labor should be treated as a commodity. That notion was outlawed in the United States in 1914 when the Clayton Anti-Trust Act was enacted with the declaration that "labor is not a commodity," exempting unions from legal characterization as a trust. The growth of unions in the U.S. during most of the intervening 70 years helped provide an income distribution to foster a balanced economy that grew over the long run.

The international economy does not have an income distribution that fosters balanced economic growth, even to the less than satisfactory degree that is currently found in the United States. Until such time as the wage gap can be narrowed to greatly reduce the competitive price advantage, there should be fair trade import quotas for developing nations to permit them limited shares in the U.S. market for various products without overwhelming the U.S. productive economy and contracting that market to the detriment of all concerned.

Attachments

Statement by the AFL-CIO Executive Council

on

The Trade Deficit

February 19, 1985
Bal Harbour, FL

America's trade problems have reached crisis proportions. The decline of the U.S. international economic position has caused untold hardship for millions of American workers and scores of communities, and threatens the economic health and security of our nation. Unfortunately, the Administration clings to a belief in mythical market forces and in an illusory free-trade theory at a time when positive action is desperately needed to reverse the erosion of America's industrial base.

The legal framework governing America's international trade was designed in an era when total trade was less than 4 percent of the gross national product, when little more than raw materials were imported from developing countries, and when tariffs were the main form of government action affecting the flow of goods in international commerce. Today the picture has radically changed. After two decades of meteoric growth, imports of manufactured goods account for more than one-fourth of overall U.S. industrial consumption, virtually all manufacturing output competes with foreign-made products, and vital sectors of our economic base have been decimated by import competition. In the 1980's, the newly industrialized low-wage countries of East Asia and Latin America have become "new Japans," challenging American producers abroad and in our own backyard, while new potential competitors with still lower wages are seeking to follow in their path.

The failure of America's traditional approach to the basic issues of industrial and trade policy is starkly highlighted in the trail of red ink that records America's worsening trade deficit. Our country did not have a trade deficit in this century until 1971. By the later 1970s, that deficit had grown to $40 billion annually. In 1984, the U.S. trade deficit reached $123 billion overall, with an $89 billion deficit directly in manufactured goods. Some are predicting that the trade deficit could rise to $250 billion by the end of the 1980s. These mind-numbing dollar losses have already resulted in the loss of over 3 million jobs, primarily in manufacturing industries, and have caused serious damage to America's industrial base, with prospects of more to come unless effective counteraction is taken soon.

This trade crisis is now striking at every point on the industrial spectrum, from labor-intensive to capital-intensive industries, high tech and low tech, from the oldest to the newest industries. No sector is immune.

Complete solutions to these problems will require effective national industrial and economic policies, including specific sectoral policies, better fiscal policies and lower interest and dollar exchange rates. Over the last 4½ years, the value of the dollar has risen some 70 percent against the currencies of U.S. major trading partners, raising the price of exports and lowering the cost of imports. The absence of effective remedies to address domestic injury caused by imports has worsened the impact of the vastly overvalued dollar.

U.S. trade law and policy must be brought into line with today's trade realities. The academic abstractions of free trade and natural comparative advantage, if they ever had any relevance, are inadequate guides for the real world of international commerce in the 1980s. U.S. trade law must be modernized to reflect contemporary realities in a world where the U.S. is the only country which exposes its industrial foundation to unlimited erosion from imports.

We emphasize that conserving American jobs and conserving American industries are political decisions for which members of Congress must be accountable, and the Administration must be held fully responsible.

The overhaul of U.S. trade law needed to remedy general shortcomings must include:

* Injury from unfair trade practices such as dumping, subsidies, and disruptive imports from nonmarket economies must be fully remedied by U.S. law. At present, too many of the injurious practices developed in recent years escape U.S. law against unfair trade practices, and other countries can increase their unfair sales in this country without fear of penalties.

* Export-oriented industrial targeting is practiced by foreign governments that seek to expand their sales and employment at the expense of the United States or other countries. Machine tools, autos and auto parts, refined petroleum products and chemicals, and electronics are some American industries that have been injured by these export-oriented targeting strategies. U.S. laws designed long before these practices developed should be revised to provide effective relief.

* Providing relief to U.S. industries injured by imports is a right recognized under international law, but the U.S. standards for qualifying for such relief are stiffer than international rules require. The U.S. standard for import relief in the "escape clause" (Section 201 of the Trade Act) should be eased, specifically recognizing plant closings and layoffs as signs of serious injury in qualifying for relief.

Beyond general reform of existing trade law, many specific trade-related problems remain to be solved. The difficulties encountered by individual industries require remedies tailored to their own special circumstances:

* Domestic content laws continue to be necessary to help assure that the U.S. remains a producer of autos. Priority should be given to a multi-year

extension and revision of the Voluntary Restraint Agreement with Japan -- based on a percentage of U.S. sales rather than on a fixed number.

* The President's national policy for import restraints on steel must be fully implemented and the Steel Import Stabilization Act must be vigorously enforced, particularly with respect to modernization and the training of displaced workers. Should the import restraint program prove ineffective, quota legislation will be necessary.

* The President must immediately implement the Congressional direction to negotiate voluntary production restraints on copper. If Congressional intent is ignored, legislation will be necessary to maintain a vigorous domestic industry.

* To revive the U.S. maritime industry, legislation is needed to substantially increase the portion of cargo carried in U.S. flagships and to assure a strong U.S. shipbuilding base thereby enhancing national security. Further, immediate action is necessary to eliminate foreign barriers to U.S. transport carriers involved in international commerce.

* The prohibition on Alaskan oil exports should be maintained, and carriage of the oil retained for U.S.-flag vessels.

* Despite the theoretical safeguards contained in the Multi-Fibre Arrangement (MFA), imports of textiles and apparel have continued to increase dramatically in the last two years. The Textile and Apparel Recovery Act of 1985 is needed to make the promise of MFA a reality and to roll back imports to a reasonable and stable level.

* Following the International Trade Commission (ITC) denial of import relief for the shoe industry, imports of footwear have captured 73 percent of the domestic market. Under mandate of Congress, the ITC has

reopened the case. If the industry is to survive, relief must be recommended by the ITC or further Congressional action will be required.

- Since the AT&T divestiture, imports of telecommunications products have inundated the American market, while foreign markets remain closed to American goods. Legislation is needed to correct this inequity and reduce the level of imported products.
- Policies should be pursued to maintain and re-establish domestic electronic and television industries.
- The manufacturing clause of the Copyright Law must be extended permanently in order to protect against widespread loss of jobs throughout the U.S. printing industry. The U.S. can ill afford another unilateral giveaway of U.S. production.
- The AFL-CIO reiterates its opposition to semi-conductor tariff cuts and the establishment of bilateral free-trade areas.
- Policies should be enacted to assure that a significant portion of U.S. raw materials destined for export, such as grains and logs, are processed in this country.

In addition to the individual industry requirements, other trade-related measures are necessary:

- The Trade Adjustment Assistance program which is due to expire in September 1985 must be renewed and funding restored in order to assist those workers displaced by imports.
- Export promotion should continue as an important function of trade policy. Export-Import Bank funding, including direct loan authority must be maintained in order to provide U.S. industry with tools necessary for international competition. These funds should be made available for the domestic purchase of U.S. products

to offset foreign subsidies. Financing, however, should not be used to develop projects in other countries in industrial sectors where excess capacity exists.

* While exports are important for domestic economic growth, the transfer of U.S. technology must be controlled to assure continued technological advances, national security and competitive advantage for domestic production.

* In addition, Congress must enact restrictions on U.S. trade and investment with South Africa as an important means of pressuring that country to end its policy of apartheid.

* Policies must be enacted to regulate the immense flows of international investment. Existing codes of conduct for multinational enterprises must be better enforced to protect the rights of workers employed by these firms and to provide effective remedies when those rights are denied.

* Current Administration emphasis on overseas investment by American firms must be redirected. Authority establishing the Overseas Private Investment Corporation should be allowed to expire this year. Emphasis should be placed on furthering the interests of the U.S. economy and U.S. workers, not multinational enterprises.

If a new round of trade negotiations develops, as the President has suggested, priority should be given to correcting problems that remain from the impact of the 1979 multinational trade negotiations. The results promised in 1979 have not been achieved, and steps should be taken to reassert U.S. interests. In addition, before the United States begins multilateral trade negotiations on trade in services, a clear definition of services and adequate information must be developed. This information must include reliable statistics and an assessment of the employment effects of trade in services.

The United States must not negotiate away domestic employment for business access to foreign markets. Meanwhile, negotiations on services trade should be conducted bilaterally on a case-by-case basis. Where unfair foreign barriers against U.S. services have negative effects on U.S. employment, the government should promote the interests of domestic service industries. U.S. law and practice establishing standards in the service sector must not be weakened.

While disappointed with the extension of the Generalized System of Preferences (GSP), the AFL-CIO applauds the addition of strong labor rights provisions in that program and will work to ensure their effective implementation.

America needs to explore a more realistic general framework for coordinating world trade relationships in sectors characterized by global overcapacity and widespread import controls. The United States operates as if the trade-regulating measures of other countries did not exist -- or as if they were irrelevant in determining whether trade is likely to injure U.S. workers and industries.

The temporary and often ineffective U.S. regulation of imports in many sectors has not accomplished its purpose; other countries have dealt more effectively with international trade to promote industrial development -- and employment. At least when there is widespread import injury, and when trade problems have led the major importing countries to apply import restraint, then the U.S. should negotiate an effective multilateral framework for allowing sectoral trade to take place in a rational manner, the same time preserving our vital economic industrial base and jobs.

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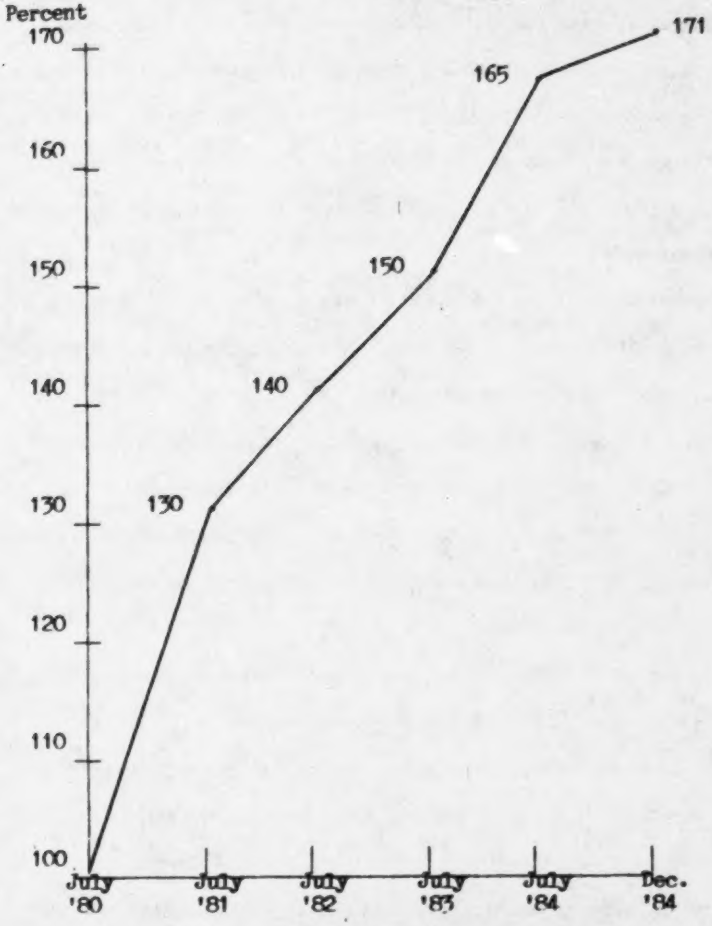
Fact Sheets

Rise in Value of the U.S. Dollar - July 1980 * to December 1984
Trade Weighted Average of Major Trading Partners



Currency Units per U.S. Dollar

	Dec. 1984	July 1980	% Change Since July 1980 *
German Mark	3.11	1.75	71
French Franc	9.51	4.06	126
Canadian Dollar	1.32	1.15	14
British Pound	0.84	0.42	91
Japanese Yen	248	221	10
Italian Lire	1,913	832	124

* Date of the lowest weighted-average exchange value of the dollar since exchange rates were allowed to float.

February 1985

TRADE
FACT SHEET

U.S. BALANCE OF TRADE
(Billions of Dollars)

	Merchandise Trade Balance	Manufactured Goods Trade Balance
1970	- 0	2
1978	- 39	- 12
1979	- 42	- 2
1980	- 40	13
1981	- 36	5
1982	- 43	- 11
1983	- 69	- 38
1984	- 123	- 89

BILATERAL U.S. MERCHANDISE TRADE BALANCE - 1984
(Billions of Dollars)

[illegible]ada	$ - 21
[illegible]pean Economic Community	- 13
Japan	- 37
Mexico	- 6
Taiwan	- 11
Republic of Korea	- 4

February 1985

American Federation of Labor and Congress of Industrial Organizations

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March 14, 1985

The Honorable James Baker
Secretary
Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

I am writing to convey the AFL-CIO's position on the Treasury Department's Tax Simplification and Reform proposals.

As you know, I and other AFL-CIO officers and staff members have met with Treasury officials on several occasions to gain better understanding of the Treasury's perspective and the implications of the proposals. The proposals have been the subject of considerable study and discussion among trade unionists and were considered in detail at the AFL-CIO Executive Council meeting last month.

We believe that insofar as the Treasury's recommendations take the poor off the tax rolls and put corporations and wealthy tax avoiders on, they represent a major step in the direction of tax justice; however, among other concerns, we are firmly opposed to the attempts to tax employer-paid benefits such as group life and health insurance, education assistance, prepaid legal assistance and child care, as well as unemployment compensation and workers compensation.

These benefits meet specific national and economic goals. They are not frivolous "perks" in the law which reduce the taxes of an elite few.

Job-related health insurance plans, for example, protect over 140 million Americans, union and nonunion. We believe that imposing taxes on such protections would encourage employers to attempt to freeze or revoke these and other benefits. This would undermine these essential life support systems and would add to inequality and injustice.

We also believe it would be wrong to eliminate the deductibility of certain state and local taxes. That proposal would severely impair the ability of states and localities to meet their own fiscal needs and would have a particularly severe impact on the more heavily populated industrial states where taxes on personal incomes, homes, and consumer purchases are the major revenue producers.

We are also deeply concerned over the insistance upon "revenue neutrality" as a prerequisite for tax reform. In large part because of the huge and continuing revenue drain of the 1981 Tax Act, the tax structure is incapable of meeting the revenue needs of the nation. The emphasis on revenue neutrality in effect preempts any use of closing tax loopholes in reducing the deficit. We believe this is wrong and that sooner or later legislators will be forced to recapture lost revenues.

We also believe that a major restructuring of the tax system as proposed by the Treasury should also enhance the progressivity of the tax structure. Therefore we question the stress on "neutrality" in terms of the overall distribution of the tax burden. A number of studies have shown that the disparity in income distribution, before and after taxes, has increased in recent years. We believe the Treasury's sights should be set higher than merely preserving the present distribution of the burdens among income classes.

We are looking forward to further opportunities to comment as the proposals are redrafted. We hope the final proposal is one that is truly fair and a measure that we can whole-heartedly endorse.

Very truly yours,

President

The CHAIRMAN. Mr. Oswald, we have had 180 degree conflicting testimony as to whether or not the dollar will appreciate or depreciate if we have a surcharge. Now you think that it will not appreciate.

Mr. OSWALD. That's correct, Mr. Chairman.

The CHAIRMAN. Tell us why.

Mr. OSWALD. We believe that the dollar will depreciate because of the increased revenue that comes into the Treasury will have the result that we will have a smaller deficit, but there will also be lower interest rates because of that smaller deficit. And that the impact will be that there will be, thus, a decrease in the value of the dollar as a result of the impact on interest rates coming about from both the Treasury impact and the fact that it will have to borrow less in terms of—because of the lower Federal deficit.

The CHAIRMAN. I'm inclined to agree with you, and yet they are all credible witnesses.

Mr. OSWALD. Well, part of it, I think, Mr. Chairman, is we have had great difficulty in explaining how rapid the rate of the dollar increase has been over the last 4 years. And while there is some theory to explain it, nothing to the—how great it has been. And the strongest pressure, of course, has been our very high interest rates. And those are clearly related to our very big Government deficits.

The CHAIRMAN. One point you make in your statement is that lost revenues should be recouped by closing loopholes that benefit businesses and wealthy individuals.

Apart from the taxation of employee benefits, you ought to generally like the thrust of the Treasury bill last November, I take it.

Mr. OSWALD. In general, Mr. Chairman, we do except for the question of tax neutrality.

The CHAIRMAN. Taxing what?

Mr. OSWALD. Tax neutrality. We are not totally sure that if those people who have been escaping paying their fair share of the tax—all that money recouped necessarily has to go in terms of reducing everybody else's tax rate.

We certainly do have a substantial budget deficit problem. And it doesn't seem to me that the answer is clearly to say these other people finally are going to pay their fair share of taxes. And the only thing we can do with that is to——

The CHAIRMAN. Lower somebody else's.

Mr. OSWALD [continuing]. Lower somebody else's taxes.

The CHAIRMAN. You might perhaps have a preferable use of the money.

Mr. OSWALD. Yes.

The CHAIRMAN. All right.

Now, Mr. Fox, will a drop in the value of the dollar, if it happens soon—let's say we have passed this budget resolution and indeed we enact it and indeed we pass the laws that cause us to drop $50, $100, $150 billion over 3 years in spending—will that be rapid enough, one, to bring the dollar down, and, two, to stem the outflow and to bring back those manufacturing industries that we have already seen go overseas?

Mr. Fox. My view, Senator Packwood, is that the budget reduction, deficit reduction, of the size that you indicate would definitely have an impact on the situation.

I'm not sure it would bring the dollar down in the short run. I hold the view that it might even strengthen the dollar temporarily. Foreigners would say, gee, that economy is really working in the United States. They've overcome that one flaw. Namely, the flaw in fiscal policy.

But I think ultimately we don't have any choice. We have to.

The CHAIRMAN. And, therefore, more money comes in.

Mr. Fox. More money comes in.

The CHAIRMAN. Which ought to cause the interest rates to go down.

Mr. Fox. Which ought to cause the interest rates to go down.

The CHAIRMAN. Although the value of the dollar would go up, is what you are saying?

Mr. Fox. Yes. Until it's realized that our fundamental accounts, our international accounts, are out of balance. Then the hoped for soft landing becomes a less likely possibility and the hard landing becomes a probability.

So I think we have no choice. We simply have to reduce the budget deficit. And the sooner we get at it, the better.

I also give immediate emphasis to exchange rate cooperation, as sort of a bridging mechanism, as well as a step toward longer term reform of the international monetary system.

The CHAIRMAN. You are saying we have to do it on the budget, forgetting the international trade situation. We need to do it domestically, I recall, is your position.

Mr. Fox. I wouldn't say forgetting the——

The CHAIRMAN. Not forgetting it but you would do it in any event.

Mr. Fox. We would do it in any event and we think we have no choice about it, so let's get at it.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. I questioned some of the earlier witnesses on the degree to which they think this problem is imminent. That is, a hard crash landing. What's your feeling about that? How close are we?

Mr. Fox. I have an absolute conviction that it is unknowable. To try to be more responsive, Senator Baucus, it being unknowable, I'll give you a guess. I think a budget deficit of a large size, the $150 to $200 billion range, can be financed by conventional means for quite a while. And Roger Kubarych, the senior vice president of the Federal Reserve Bank of New York, wrote an article on this about a year ago which indicates that financing the deficits so long as we have no recession and so long as the inflation in the United States is no greater than now, that the financing of the deficit could be done for some while.

My opinion is the end of this game will come in a recession. The precise date of this recession cannot be foretold, of course. But the recession will be related to our international accounts, particularly the inability to bring the trade account around and then the continued Federal borrowing abroad, making the rest of the current account totally out of balance. Foreign money would stop coming in and indeed would begin to move out. The Federal budget deficit could no longer be financed with foreign money.

These events would create the conditions for the hard landing.

Senator BAUCUS. Do you tend to agree with that, Mr. Oswald?

Mr. OSWALD. I would only add that the real problem—one cannot forecast exactly when that hard landing is going to come. The real problem then is the recession, and there is some question of whether we are already moving into that. And clearly the levels of unemployment are still at what we call recession levels before. But what we have removed is the flexibility of having any fiscal ability to offset a recession when it comes.

We have very little ability to keep that deficit from mounting very strongly, and we have taken away any countercyclical or fiscal policy alternatives because of the budget deficit problem as we go into the recession.

Senator BAUCUS. Do you both think that the President should raise the question of currency values in Bonn?

Mr. OSWALD. I agree with the French who say that we need to get moving on the value of the currency; that it should be linked with any new trade talks because the two are clearly related.

Senator BAUCUS. You think the President should raise the issue?

Mr. OSWALD. And go much further than the Secretary of the Treasury has proposed.

Senator BAUCUS. Mr. Fox?

Mr. FOX. I definitely agree with you. The paper I referred to, the one of April 10, was specifically prepared by NAM for the State Department urging that course of action. That monetary discussions be begun along side the trade talks.

Senator BAUCUS. Thank you very much.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Fox, we were operating under the old Bretton Woods agreements when I came here to the Senate, and after a while the Bretton Woods agreements weren't doing the job. Mr. Luce and others saw that, and they worked to move us away from the old system. I guess it was under the Nixon administration that John Connally moved strongly toward a system of floating rates.

And now the floating rate system is not working. It's a disaster for us. And it seems to me that, that being the case, the United States as the big loser in all of this ought to take the lead in saying you can't do business that way anymore. Now Mr. Roosa suggested here that he felt Britain and France and Germany would be willing to join us in working out a new arrangement to fix the value of currencies. Does that have a lot of appeal to you?

Mr. FOX. Yes, it does. I think it's the only way to go. I think a big mistake was made in 1973 when the United States made no effort to defend the new rates. You see, there were two devaluations—in August 1971 and then in March 1973. Then we let the whole thing go to floating. We couldn't arrange any criteria against which the floating would work. It seemed that floating was helpful in meeting the problems created by the oil price rise. But what was unforeseen was the consequences of the capital movements replacing trade as a determinant of a currency's value.

I think that ultimately we will move in the direction of some kind of broad target zone system. I don't think there is any question that the other members of the SDR—Special Drawing Rights of the IMF—Japan, UK, France and Germany, would be prepared to take a look at a new system. But absent leadership from the United States, things just drift along. And as I pointed out this morning, these exchange rates are really not all that bad from the standpoint of Europe. It's created what little economic activity they have in exports to us. And the Japanese, despite the complaints, tolerate it quite nicely. The Japanese could have moved the yen. They could have put an export tax on their exports to the United States so their prices would not have been cheaper and their budget deficit would have been less. They might have been more comfortable with that. They chose not to do it. They chose to take advantage of this quirk in exchange rates, if I might use that expression, or fatal flaw, which I really feel is more apt.

Senator LONG. Well, it seems to me to leave all this disaster which is building up to the fate of the currency market, including the illegal drug traffic crowd, is a pretty silly way of doing business when you leave off the scene the one thing that could be used in the interest of 230 million Americans. That is, the Government itself taking an interest in how much currency there is in circulation, and what the value of that currency is going to be compared to other people's currency.

Now do other governments have some say about what their currency is worth?

Mr. FOX. I think every country, except the United States, has an exchange rate policy. In every other country, there are three elements of macropolicy—monetary policy, fiscal policy, meaning budget policy, and an official view or a view with respect to the exchange rate.

The United States had such a policy until August 15, 1971. The Bretton Woods system gave us an exchange rate policy. I think from 1973 to 1985 should provide sufficient time to indicate that the market alone will not necessarily provide the right exchange rate for the United States if one assumes the right exchange rate is one at which we can sell manufactured goods, farm goods and the goods produced by our mining industry. If you think that the tradeable goods sector of the economy is important, then you have to look to the exchange rates and seek some means of achieving a better exchange rate.

I'm unwilling, although I would like to believe it, that just good monetary and fiscal policy would do it. I think you need a third element. You need an exchange rate policy, and it has to be in the context of an improved exchange rate system.

Senator LONG. I'd like to ask a question or two of Mr. Oswald, if I may, Mr. Chairman.

The CHAIRMAN. Go ahead.

Senator LONG. Mr. Oswald, I gained the impression that you are an economist. Is that correct?

Mr. OSWALD. That's correct.

Senator LONG. Yes, sir; well, I'm glad to know it.

Now I have been concerned about a matter you heard me discussing in previous questions. European countries and the Japanese in their own way have a way of taxing consumption with value added taxes or whatever Japan uses, which have the same effect, I'm told. They are charging us that tax at the border when we enter their markets. That is wiping out a lot of competitive disadvantages that would otherwise exist as far as they are concerned.

Now it seems to me that the burden of all these items that I discussed previously with a previous witness—I think the gentleman from MIT—you are talking about the cost of Social Security, health benefits, unemployment insurance, environment, safety, you name it. Under our system all that burden falls on our manufactured product and there is no offset. We are not in a position to rebate it at the border as the other countries do, and we are not in a position to charge it to our competitor when he enters our market, as they do with the European tax.

Now I've been able to convince Mr. Frazier, for example, when he was in his last years over at the UAW that we ought to be moving in that direction. We need somebody in the labor movement to help those people to understand that this disparity in the way that we tax compared to the way those people tax is costing us a lot of jobs.

Do you think you can begin to explain that to Mr. Kirkland and some others over there in that AFL-CIO?

Mr. OSWALD. Well, Senator, I think part of it is what we negotiated in the GATT. I'm not totally clear, particularly in hindsight, why we allowed one set of taxes to be rebated at the border and be imposed on imports, which we have allowed on value added taxes.

Senator LONG. Well, let me just straighten you out on that in a hurry.

Mr. OSWALD. We could do the same thing on Social Security taxes.

Senator LONG. Hold on just a minute. Let me tell you why that's the case. I don't like it either. But I could explain that to you easily.

We had somebody over there in Geneva that agreed to that back in a time when we were rich and the other guy was poor. And being in that trap, we proposed to go along and keep the agreement even though it's not to our advantage at all. But we could change that.

Mr. OSWALD. That's correct.

Senator LONG. Now, for example, we could put some other tax on and just give a credit for the Social Security tax.

Mr. OSWALD. Or we could even negotiate that we do get a credit. We would have more money for the Social Security system because obviously we have more imports than we have exports. And the Social Security system would be ahead.

Senator LONG. Mr. Oswald, you would make a big mistake trying to negotiate yourself out of that trap. They will make you pay something to get there. And I don't think you ought to have to pay to get something when you could achieve the same result without it. In other words, all we would have to do is to substitute a value added tax for Social Security tax. It would have the same impact as far as the consumption is concerned. It's no more regressive than the Social Security tax we have.

Or just to levy a value added tax and provide a credit for the Social Security tax. We could do something of that sort. There are ways that it could be done. I know some of business people who are thinking in those terms. Trade is a great big burden that's hurting your workers. And we ought to be doing something to correct it.

Mr. Fox, have you been giving some thought to that and your people?

Mr. Fox. Yes; let me say this first about the history. The GATT provision with respect to taxation was part of the Havana charter. It was really written by Americans who were thinking of a 10-percent tax on women's pocketbooks. They were contemplating a tax which, by and large, the retailer would pass forward. They were not thinking of a tax that ran across the whole economy like VAT—value added tax.

So the differentiation in the GATT has that historical basis which I think by and large is no longer accepted by economists. I think economists feel that depending on the nature of the market, taxes will always be passed forward whether they are the VAT or an indirect tax or corporate tax.

But the GATT is very, very difficult to change now, particularly if it's adverse to the interest of some parties, as it would be in this instance.

My own opinion is that since the VAT is perfectly legal under GATT; it represents a convenient source of tax; it can be made nonregressive. Therefore, it's a good tax to take a look at. The NAM position with respect to the current budget deficit is that as much as can be done should be done on the expenditure side. But if we ever reach the point where the Congress and the President are at that "last resort stage" and they say it's time to consider a tax, we would say a value added tax or a consumption tax, and partly for trade reasons.

Senator Long. It seems to me that we are in this silly situation about our taxing system that it gets now to the question that it's not what you do, it's the way that you do it that makes the difference. You can raise the same amount of money with a tax on consumption and it has the same impact on the consumer and the same worker as you do with the Social Security tax. You could raise the same amount of money in a way that insofar as the difference, it's a difference that's immaterial. The same relative impact as far as the taxpayer out there is concerned, and the ordinary American citizen and worker is concerned.

But you can do it in such a way that you can do to them what they are doing to us.

Mr. Fox. I'd make only this comment. So long as you are going to do something in accordance with the GATT, you might as well do it in accordance with the GATT.

Senator Long. Yes.

Mr. Fox. A straight value added tax permits you to do that. Once you move to Social Security, there would be a big question as to whether you could do it. And, of course, other countries have Social Security taxes. So the Europeans might rebate part of their Social Security tax and you would get into an escalation of rebates. I think it would be better to do a value added tax in its traditional form. There is much revenue to be gained from that value added tax, as the Congress thinks wise to try to gain——

Senator **Long**. Well, now, if you can do it that way, Mr. Fox, that's fine. But you may not be able to do it that way. Politically, you might not be able to get the votes to do it.

Now I know what we did about the DISC. We started out with the DISC to try to meet some of the same problems. And the GATT people argued that that was not GATT legal. And so we refused to repeal it. We stayed with the DISC for a while, and after a while, they figured out that we could achieve the same result with the FISC. F-I-S-C, they call it.

So we repealed the DISC and substituted the FISC for it. And so now they could take us back to GATT if they want to, but if they kill the FISC, then we will think of something else. I believe the FISC is probably GATT legal.

Mr. **Fox**. My observation is fairly simple, Senator Long. The value added tax is perfectly legal. There would be no objection to it. And it can raise as much revenue as is determined to be necessary and it creates no problems under the GATT.

Once you move to Social Security, you do open up an area of confrontation which in my opinion isn't necessary.

Mr. **Oswald**. Senator, I would just like to differ, if I may, on this general value added tax. We have been concerned, as you know, for a long time that various proposals would try and make a value added tax even more progressive or very difficult to do. There are very great difficulties for trying to exclude from the tax those who—and the effect of the tax—those who are the poorest in our society. We really don't have the ways of rebating taxes to those and we have serious problems on the effects of such taxes on our society.

Second, we do think that the progressive income tax is the fairest and best way in the long run to assess the cost of government on our society based on ability to pay and who really achieves the most from our American system.

Senator **Long**. Well, Mr. Oswald, we have had very little experience using a negative income tax. But we have made a breakthrough right here on this committee. We advocated for years before the House went along with what is now the earned income credit. But it's the law. I mean we've already established that we can have a negative income tax, if we want to, and we have it at the moment with the earned income credit.

Now I wish you would find some time to discuss this matter with Mr. Lester Thurow because he is an eloquent advocate of the idea. In fact, I think he's convinced a Senator or two against their will.

But it's not so much whether you are using the income tax or whether you are using the Social Security tax or the excise tax. The question is how does the overall mix work out when you get down to the bottom line and you put the whole thing together. Does it work out to a fair tax system or does it not?

I think we sometimes confuse ourselves when we put something as liberal as a negative income tax in the mix. I think we sometimes confuse ourselves by saying, well, this tax is not as fair as the other tax when the final result is what I think we ought to be focusing on.

I hope that you will help sell that idea to your group because unless I miss my guess, you know just a lot more about economics than most of them do.

Mr. OSWALD. I have studied the question for a very long time.

The CHAIRMAN. Gentlemen, thank you.

[Whereupon, at 12:25 p.m., the hearing was concluded.]

[The following statements were submitted to be a part of the hearing record.]

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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510

APRIL 22, 1985

MEMO

FROM: FINANCE COMMITTEE STAFF (LEN SANTOS x4-6953)

TO: FINANCE COMMITTEE MEMBERS

SUBJECT: THE ROLE OF FLOATING EXCHANGE RATES IN THE INTERNATIONAL TRADING SYSTEM

The Finance Committee will conduct hearings on April 23 and April 24, 1985 on the viability of the international trading system in an era of floating exchange rates. The hearings are scheduled from 9:30 a.m. to noon on April 23 and 24, as well as from 2:30 p.m. to 4:30 p.m. on April 23. The hearings will be held in SD-215. A list of the witnesses is attached hereto.

I. ROLE OF EXCHANGE RATES

An exchange rate is the price of one currency in terms of another currency. The foreign exchange market, where one currency is exchanged for another, is a network of commercial banks, brokers, central banks, and customers who communicate easily with each other. When one dollar buys fewer units of a foreign currency, the dollar has depreciated; and conversely, when one dollar buys more units of a foreign currency, the dollar has appreciated. When a country's currency appreciates, its exports increase in price in terms of other currencies and imports diminish in price in terms of its own currency.

II. THE BRETTON WOODS ERA

A. The Rationale

The negotiations that established the postwar international monetary system at Bretton Woods, New Hampshire, in July 1944, were heavily influenced by a desire not to repeat the major mistakes of the period between the wars. The British and American planners of the postwar monetary order saw fluctuating and misaligned exchange rates, completely free capital movements, and completely autonomous national monetary and fiscal policies as incompatible with an open trading system and the achievement of high levels of employment and growth. They wanted collective intergovernmental management of the quantum of international liquidity, of international capital flows, and of exchange rates and national adjustment policies. Sir Kingley Wood, British Chancellor of the Exchequer, summarized this view in 1943:

> "We want an orderly and agreed method of determining the value of national currency units, to eliminate unilateral action and the danger which it involves that each nation will seek to restore its competitive position by exchange depreciation. Above all, we want to free the international monetary system from those arbitrary, unpredictable and undesirable influences which have operated in the past as a result of large-scale speculative movements of capital. We want to secure an economic policy agreed between the nations and an international monetary system which will be the instrument of that policy. This means that if any one Government were tempted to move too far either in an inflationary or deflationary direction, it would be subject to the check of consultations with the other Governments, and it would be part of the agreed policy to take measures for correcting tendencies to dis-equilibrium in the balance of payments of each separate country."

1. Liquidity

This collective intergovernmental management of money proved impossible, and the world turned to the dollar standard, in which international reserves were determined mainly by the balance of payments deficits of the United States.

2. Capital Movements

Collective international monetary management proved no more feasible for capital movements than it did for liquidity creation. The IMF articles approved at Bretton Woods provided for freedom from exchange controls only on current transactions; significantly, the postwar planners envisaged that countries would need the latitude (and, in extreme cases, should be required) to control disequilibriating movements of short-term capital. The Anglo-American planners of Bretton Woods believed that governments would have to protect the system against the uncontrolled activities of private banks. Secretary of the Treasury Henry Morgenthau went so far as to describe the purpose of the Bretton Woods Conference as "to drive the usurious money lenders from the temple of international finance." The widely-held view at Bretton Woods was that the great volality of exchange rates and massive flows of speculative and flight capital during the period between the wars were prima facie evidence of the distablizing and disequilibriating nature of capital flows and the undesirability of floating exchange rates.

3. Adjustment

Finally, international monetary management also proved inoperable for the international adjustment process. The postwar monetary order was to be based on fixed exchange rates, which could be adjusted to correct a "fundamental disequilibrium" through a process of international consultation and agreement. But it proved impossible to agree on the appropriate balance between deficit and surplus country responsibilities. At the end of the Bretton Woods conference, national autonomy was being emphasized instead of supranationality.

B. The System in Operation

Under the Bretton Woods system, the value of the dollar was defined in terms of gold (and convertible into gold) and all the other currencies were fixed in relation to the dollar. The exchange rate for each currency could fluctuate only one percent above or below the par value of the currency--if it fluctuated more, each country was expected to buy or sell its own currency to prevent wider fluctuations. Consequently, the monetary authority of each country was responsible for maintaining the exchange rate of its currency.

1. The Role of the IMF

The IMF was established primarily to promote international monetary cooperation and exchange rate stability and to help members meet temporary balance of payments deficits. Quotas were established for each member country, which determined its voting rights and contributions. Each member contributed 25 percent of its quota to the IMF in gold or U.S. dollars and 75 percent in its own currency. Member countries could then borrow from the IMF (with the IMF imposing conditions which were more restrictive the greater the percentage of a country's total quota that the member was borrowing) for balance of payments financing.

It was anticipated that the short-term balance of payments deficits and surpluses would be adjusted by using international reserves or by borrowing from the IMF, while long-term surpluses and deficits were to be adjusted by changing the par value of a country's currency (devaluation or revaluation) and by deflating the domestic economy (for example, if the economy is deflated, prices and income will decline, leading to an increase in exports and a decrease in imports, and an ultimate improvement in the balance of payments).

2. The System Under Stress

In the 1960s it became apparent that the Bretton Woods system had serious deficiences. First, U.S. dollars were the world's currency and increases in world liquidity depended on increases in U.S. balance of payments deficits. At the same time, other countries were less willing to hold dollars as the U.S. balance of payments deteriorated. Secondly, the large deficit countries could not devalue their currencies, because other countries would follow and the devaluation would be ineffective, while upward revaluation of currencies for surplus countries, which would have hurt their export industries, was not attempted. Third, deficit countries were unwilling (and sometimes legally unable) to deflate their economies because of domestic economic pressures and surplus countries, where the problems were not as imminent as for deficit countries, usually chose not to inflate.

The United States experienced larger and larger balance of payments deficits in the 1960s. The deficits provided a much needed increase in international reserves because the countries receiving these dollars as a result of balance of payments surpluses retained them as an international reserve asset. However, the deficits also contributed to periodic speculative capital flows out of the dollar as financial market participants expected a dollar devaluation.

3. Attempts to Restore Stability

Several attempts were made to stabilize world financial markets in the 1960s. One of these was the gold pool, which was created in November 1961 in response to a flight from dollars into gold. The Bank of England, with stocks of gold contributed by central banks of eight countries, bought and sold gold in order to stabilize the price of gold. After the 1967 sterling devaluation and the expectation by foreign exchange market participants that the United States would increase the price of gold (that is, devalue the dollar), the speculative flight from dollars and sterling into gold became too heavy for the gold pool. In March 1968, the governors of the central banks announced they would no longer buy and sell gold in the private market to stabilize the price. A two-tier gold market was thus established, in which central banks would buy and sell gold among themselves at $35 an ounce, while the price of gold in the marketplace would depend on demand and supply.

4. The Nixon Shock

Speculative capital flows continued in 1969 and again in 1971. At a Camp David meeting with President Nixon in August 1971, Secretary of the Treasury Connally described how the economy was expanding too slowly, inflation was not subsiding, the trade balance was negative, and the overall balance of payments was in mammoth deficit. On August 15, 1971, President Nixon announced a tax credit for investment in U.S.-made equipment, repeal of the federal excise tax on automobiles, a speedup in scheduled personal income tax exemptions, a large cut in federal spending and foreign aid, and a 90-day wage and price freeze. Most importantly, the President announced that the U.S. government would eliminate the convertibility of the U.S. dollar into gold (thus severing the ties of gold to the international monetary system) and announced that the dollar would float against other currencies. Finally, a ten percent inport surcharge was imposed.

5. The End of Bretton Woods

In the Smithsonian Agreement of December 1971, the U.S. dollar was devalued and fixed exchange rates were reestablished, but convertibility between the dollar and gold was not reestablished. After considerable speculative activity, the U.S. devalued again in February 1973 and after further speculative pressure, in March 1973, fixed exchange rates were abandoned. This represents the end of the Bretton Woods system. Since then, exchange rates have been free to fluctuate, although governments have intervened in foreign exchange markets, heavily at times, to reduce some of the fluctuations. Consequently, the current system is referred to as a "managed float."

III. THE FLOATING EXCHANGE RATE ERA

A. 1972-1976

Adoption of floating exchange rates was a crisis response to unsustainable disequilibrium in the foreign exchange markets rather than a planned international monetary reform. After the second initiation of exchange rate flexibility in 1973, the announced objective of official reform negotiations was to secure prompt return to a system of "stable but adjustable" par values. The negotiations on international monetary reform by the Committee of Twenty (C-20) during the period 1972-74 gradually accepted the feasibility of floating exchange rates. Negotiators slowly recognized that a return to the par value system was neither feasible nor urgently needed. But agreement on floating exchange rates as the basis for the international monetary system was not achieved until the meeting of major industrial countries at the meetings of the heads of state at Rambouillet, France, in November 1975. Agreement on the full reform package was secured at the meeting of the Interim Committee of IMF Governors at Kingston, Jamaica in January 1976. The Jamaica agreements accept floating exchange rates while reaffirming the importance of international cooperation and exchange rate stability.

B. Floating Exchange Rates in Operation

Assuming exchange rates are determined in a free market (no government intevention), the rate is determined solely by the supply and demand for dollars. If the supply of dollars is greater than the demand, the exchange rate will fall (i.e., the dollar will depreciate--one dollar will buy fewer units of a foreign currency). On the other hand, if the demand for dollars is greater than the supply of dollars, the exchange rate will rise (the dollar will appreciate or buy more units of a foreign currency).

1. The Role of the Dollar

In addition, the U.S. dollar plays a unique role in the international monetary system. Dollars, or dollar-denominated assets, are held as reserves by foreign central banks as well as by foreign firms and individuals and the dollar is used in payment among countries other than the United Staes as well as between the United States and other countries. Foreigners have acquired large amounts of dollars because U.S. payments abroad have exceeded U.S. recepts from abroad over a period of years.

Since the dollar was a strong currency which was accepted as payment by other countries and because the dollars held could be invested in safe, interest-earning assets such as U.S. Treasury bills, or placed in a dollar-denominated time deposit in a foreign bank (the Eurodollar market), foreigners have been willing to hold dollars. One result of the large accumulations of dollars by foreigners, however, is that whenever foreigners decide to sell dollars or dollar-denominated assets for foreign currencies, the supply of dollars on the foreign exchange markets increases.

2. Intervention in the Exchange Market

The only direct action central banks can take to influence exchange rates or to counter disorderly markets is to intervene in the foreign exchange markets by buying and selling dollars and foreign currencies. This can be accomplished either by foreign central banks or by the Federal Reserve System. For example, to prevent dollar depreciation, foreign central banks can intervene by buying dollars with their own national currencies.

If the U.S. decides to buy dollars, it can obtain foreign currencies from its stocks on hand, via swap arrangement (short-term agreements with foreign central banks to provide the Fed with a certain amount of that country's currency in exchange for dollars), by selling special drawing rights, by drawing on it reserve position in the IMF or by issuing foreign-currency denominated securities. The U.S. decision to intervene is made jointly by the U.S. Treasury and the Board of Governors of the Federal Reserve

System; the actual buying and selling of currencies is done by traders at the Federal Reserve Bank of New York.

C. Dollar Exchange Rate

The amount of depreciation (or appreciation) of the dollar differs substantially depending on which currencies it is measured against. In fact, the dollar may depreciate against one currency, while at the same time it is appreciating against other currencies. Over the past few years, the dollar's exchange rate has fluctuated most when measured against the Japanese yen, German mark, and Swiss franc.

To determine the overall depreciation or appreciation of the dollar, a trade-weighted average, in which the dollar is measured against an average of a number of currencies, each weighted by its share in U.S. trade, is used. It is likely that the dollar's fluctuations will be much smaller when measured against a trade-weighted average than against a single currency, since the former includes currencies that are both depreciating and appreciating against the dollar.

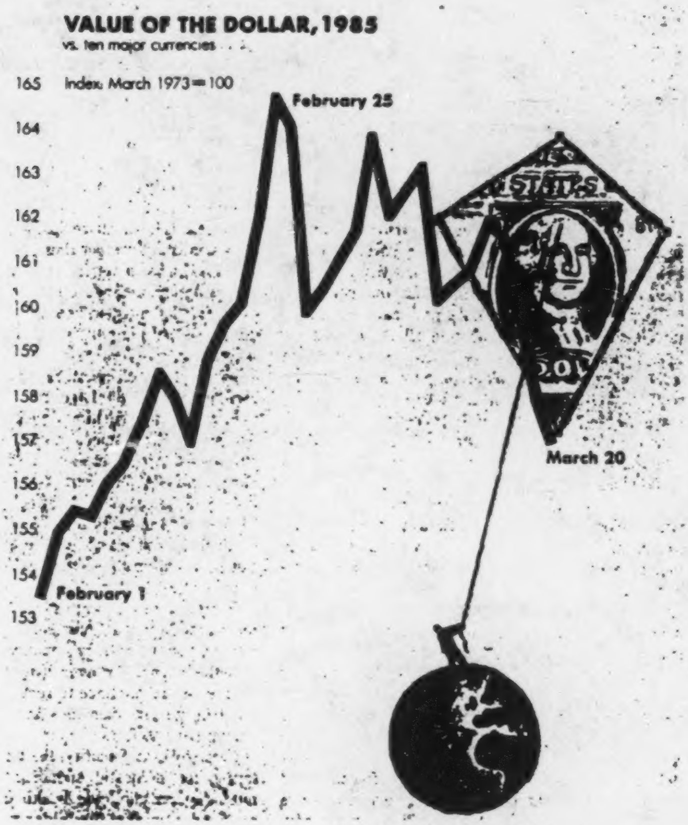
Exchange Rate Trends

Percent depreciation (-) or appreciation
in U.S. dollar relative to ---

	DM	Yen	Swiss franc	trade-weighted average
12/31/77 - 12/31/78	-13.4	-19.0	-18.9	-5.0
12/31/78 - 12/31/79	- 5.0	23.7	- 1.2	2.1
12/31/79 - 12/31/80	14.3	-15.4	11.8	0.7
12/31/80 - 12/31/81	13.8	8.2	0.3	8.6
12/31/81 - 12/31/82	6.2	6.6	12.3	8.6
12/31/82 - 12/31/83	14.2	- 1.1	8.7	5.3
12/31/83 - 12/31/84	15.8	8.6	11.9	11.3
12/31/84 - 03/15/85	7.2	3.6	10.5	NA

It should be noted that that dollar's fluctuations within years (not shown in the table) are sometimes greater than the year-to-year changes shown in the table. For example, the dollar's appreciation of six percent against the DM in 1982 reflects an appreciation of 16 percent between December 31, 1981 and November 8, 1982, and a depreciation of about eight percent between November 8 and December 31, 1982.

More recently, the dollar has experienced unusual volatility as illustrated in the following chart. During February 1975 the dollar appreciated 7.3 percent, reaching an all time high, before central banks intervened, causing the dollar to drop by six percent.



D. Causes of Exchange Rate Fluctuations

Although the exact causes of exchange rate fluctuations are not well understood, several factors are believe to be the most important determinants. These include the current account balances of different countries, relative inflation rates, relative growth of money supplies, relative interest rates, real income levels in different countries, and expectations of future exchange rate change. There are different theories regarding how these factors affect exchange rates, however, and empirical tests of the various theories have yielded inconclusive results.

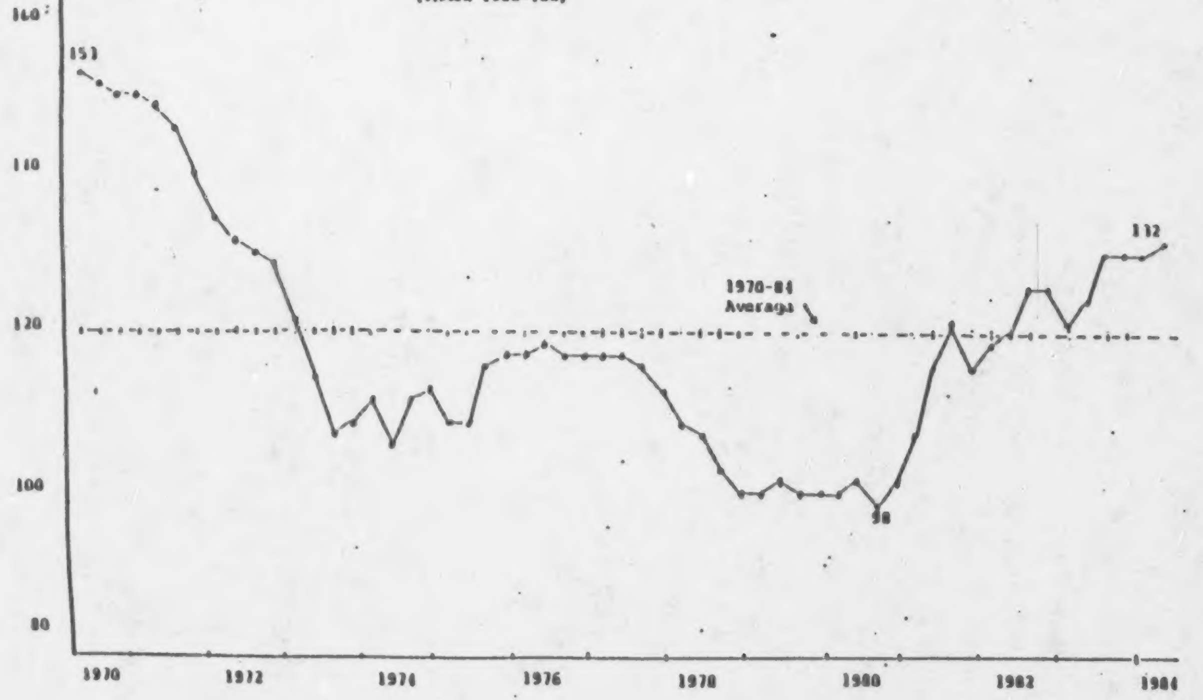
Generally, in the early 1970s, when the floating exchange rate system was established, it was thought that exchange rates were determined mainly by trade flows (capital flows were relatively small and often restricted). Trade flows, in turn, were thought to be determined mainly by relative real incomes and relative prices. For example, according to this theory, if real income in the United States increases relative to that abroad, U.S. imports will increase, leading to a worsened U.S. current account balance, an increased supply of dollars on foreign exchange markets and a dollar depreciation. Or, if U.S. prices fall relative to those abroad, U.S. exports will increase, U.S. imports will decrease, the U.S. current account will improve and the dollar will appreciate.

In recent years, however, capital flows have increased substantially and most analysts believe they are an important, and perhaps the major, factor in the determination of exchange rates, at least in the short run. For example, a foreign exchange survey by the Federal Reserve Bank of New York shows that foreign exchange transactions in the United States were about ten times the sum of annual U.S. exports plus imports in 1983. It is estimated that $20 to $30 trillion in capital now moves through foreign exchange markets each year compared with about $2 trillion in annual trade in goods and services.

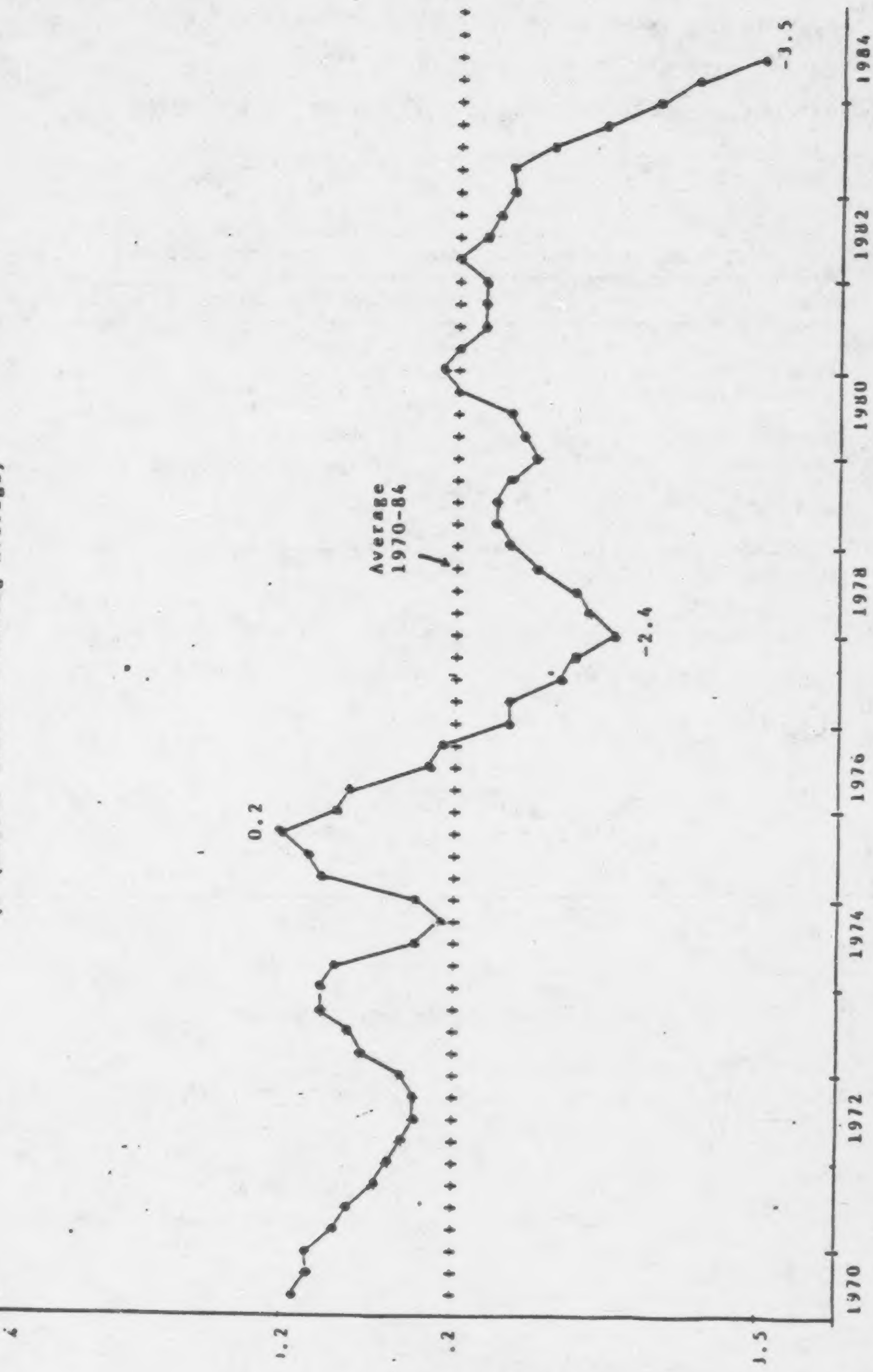
IV. TRADE CONSEQUENCES OF DOLLAR APRECIATION

Most observers agree that the appreciation of the dollar since 1979 has had a major and negative effect on the U.S. export competitiveness and has similarly improved the competitiveness of foreign products exported to the U.S. The following two tables suggest that the U.S. trade deficit grows with dollar appreciation and shrinks with dollar depreciation.

THE U.S. REAL EXCHANGE RATE,
(Index 1980=100)



U.S. Trade Deficit as a Ratio of GNP
(3 quarter centered Moving average)



The following table indicates that the U.S. net loss of competitiveness relative to Japan during 1980-1981 was about 28 percent, and 50 percent relative to Germany (and much of Europe).

U.S. Loss of Export Competitiveness in Manufacturing
(Cumulative Percentage Change of Dollar Prices: 1980-84:I)

	U.S.	Japan	Germany
Machinery and Transport Equipment	21.5	-4.7	-18.9
Electrical Machinery, Apparatus and Appliances	20.7	-2.2	-18.8
Non-Electrical Machinery	12.4	-8.8	-19.6

Source: UN Monthly Bulletin of Statistics.

This change in competitiveness, together with cyclical factors, have worked in opposing directions for the U.S. and for foreign countries.

Change in Trade Volume
(Cumulative Percent Change: 1982-84

	U.S.	Europe	Japan	Latin America
Exports	-15.0	15.0	30.3	26.4
Imports	21.0	6.2	5.0	-31.6

Source: IMF World Economic Outlook

IV. EXCHANGE RATES WITHIN THE LEGAL FRAMEWORK OF THE TRADING SYSTEM

A. The GATT

The General Agreement on Tariffs and Trade is based on the Bretton Woods system. No recognition is given the post-1973 floating exchange rate system. For example, Article II.6 of the GATT notes that tariffs are to be expressed in the appropriate currency at the "par value" recognized for that currency by the IMF. Similarly, Article XII establishes the balance of payments conditions pursuant to which a member may impose quantitative restrictions on imports. The conditions are based on the state of a country's monetary reserves, a measure rendered largely obsolete in a floating exchange rate system where a country does not choose to defend any particular value for its currency by drawing on its monetary reserves.

B. U.S. Trade Laws

As a result of the challenge to the legality of President Nixon's 1971 import surcharge, Congress enacted a balance of payments provision as part of the 1974 Trade Act.

Although the President's authority to impose an import surcharge was ultimately upheld by the courts, the section 122 balance-of-payments authority was included in the Trade Act of 1974 to insure that the President had such authority in a future crisis. That section authorized the President to impose, for up to 150 days, an import surcharge of up to 15 percent, or quotas, or both, in the event of a large U.S. balance of payments deficit, the threat of a sudden drop in the dollar's value or the need to cooperate with other countries in correcting balance-of-payments disequilibrium. Another paragraph of section 122 permits the President to reduce tariffs temporarily and take other actions to deal with U.S. surpluses. The President was directed to seek modification of international agreements with the purpose of permitting the use of surcharges in place of quantitative restrictions. The surcharge was seen as a balance-of-payments adjustment measure within the context of arrangements for an equitable sharing of balance-of-payments adjustment responsibility among deficit and surplus countries.

Pursuant to the directive of section 122, the U.S. negotiated an agreement on trade measures taken for balance-of-payment purposes as part of the Tokyo Round of negotiations concluded in 1979. The effect of the "Declaration on Trade Measures taken for Balance-of-Payments Purposes" was to give preference to surcharges over quotas, to the extent the circumstances described in GATT article XII were present. The Declaration made it clear that trade measures were not regarded as an efficient means of restoring balance of payments equilibrium, and that, should tariffs be used in place of quotas, the procedural requirements of Article XII for consultation and otherwise had to be followed.

In testimony before the Finance Committee last year, Martin Feldstein, then Chairman of the Council of Economic Advisers, testified that section 122 was a dead letter in light of a floating exchange rate system which has rendered the concept of a balance of payments deficit obsolete.

V. CONCLUSION

Some of the worst fears of the framers of the Bretton Woods system have materialized under the floating exchange rate system. Massive, and arguably speculative, capital flows of unprecedented size now determine exchange rates. Exchange rates have become more volatile. Huge trade and current account disequilibria have spawned protectionist pressures.

The rules of the trading system were designed in the context of the Bretton Woods system, a system designed to avoid disequilibrium. The breakdown of that system and the evolution of floating exchange rates raises the question of whether the trading system needs to adjust to the new exchange market reality. Over forty years since the Anglo-American "founding fathers" met at Bretton Woods, the old dilemma facing them remains - if you don't manage money, at least in some degree, won't you have to manage trade?

By: Roger J. Baccigaluppi, President
California Almond Growers Exchange

"AGRICULTURAL EXPORT: PROBLEMS AND A SOLUTION"

A few weeks ago in Sacramento, I had the privilege of addressing the National Agri-Marketing Association on the occasion of National Agriculture Day -- the first day of spring -- March 20. I indicated to that group that it was a nice thought, National Ag Day, but that there was little to celebrate. Let me tell you why.

We have on our hands today the greatest agricultural depression of this century. All of those who still remain in agriculture should be congratulated. They have survived despite a government policy to encourage cheap food for the consumer. That means low prices to the farmer.

More recently, our federal fiscal and monetary policies have been devastating to agriculture, whether it be in California, Kansas, or Illinois. We continue to hear how robust our economy is -- the leader in the world. But how long will it last?

You probably expect me to talk about the 1985 Farm Bill tonight. If you do, you are going to be disappointed. All I will say on that subject is that no matter what is enacted -- the Administration's program, a much less costly program from the standpoint of the taxpayers, or a program that costs many times the Administration's proposal -- no '85 Farm Bill is going to solve the underlying problems in agriculture that have developed in this country in recent years. Whatever Farm Bill finally evolves is going to be little more than superficial first-aid by untrained paramedics who do not seem to understand that our injuries are not superficial, but potentially fatal to agriculture as we know it today. Our injuries need to be diagnosed carefully. Only then can we take the necessary surgical action to help agriculture truly recuperate. A box of bandaids patched all over a mortally wounded industry will not make agriculture any better or more able to survive.

We have a crisis in this country that must be addressed promptly if we are to save the economic future of this nation and the rest of the world. Very strong words, but I believe them and so do many others, Republicans and Democrats alike.

The problem begins with the public perception that the economy is doing well. Perhaps a few farmers and export industries are being hurt, but the economy in general is doing very well. Given this public perception, why should Congress take action?

They must take that action, ladies and gentlemen, because our economy -- the greatest economy in the world -- is in its decline. The decline began slowly, but has now accelerated. Just four years ago, in 1981, our merchandise trade deficit amounted to only $28 billion. That means we imported $28 billion more products than we exported. Three years later, in 1984, we were importing $130 billion more than we exported, and this year it is expected to reach about $150 billion.

Why does it matter that we are importing more than five times as many Toyotas, Sonys, agricultural products, and Airbuses, to name just a few products, than we did four years ago? It matters primarily because of the trend it represents. If five times as many products have been imported in the last four years, will there be ten times as many in the next four years, and 20 times as many in the next eight or ten years?

Let me take a moment to discuss some specifics.

First, the United States has fewer trade barriers, tariff and non-tariff, than anywhere in the world. Our trading partners, on the other hand, have any number of barriers to U.S. products. We in agriculture must continue working with our government to improve this problem.

Second, the economies of most of the countries of the world have suffered badly during recent years, tending to hurt our export sales. This situation has begun to improve, but remains a problem.

The two problems I have just mentioned, however, pale by comparison to those created by the grossly overvalued dollar. It is the dollar, more than any other factor, that is choking off our exports and stimulating imports.

Some have suggested that exporters in the United States are using the overvalued dollar as a crutch to explain why they are unable to export. I would urge them to consider the facts.

In August 1980, it took 2.37 U.S. dollars to purchase one British pound. By the end of February, it took 1.06 U.S. dollars to buy one British pound.

Apply this to the case of almonds. Assume for the moment that we were selling almonds for $1 per pound in 1980 and that our prices have not changed since then. If you disregard what inflation has done to our purchasing power, the dollars we are receiving from the British are the same as we received in 1980. The British consumer, though, because of the increase in the value of the dollar and the decrease in the value of the pound, is paying the equivalent in his currency of $2.23 per pound for those $1 per pound almonds. His price, in this case, has more than doubled. What we receive stays the same.

Similarly, the French buyer is paying the equivalent of $2.57 per pound, more than 2 1/2 times as much as he paid in 1980. The German buyer is paying the equivalent of $1.95 per pound, or nearly twice as much for those $1 per pound almonds.

What has actually happened in almonds is that we have reduced our price by one-third from $1.88 per pound in 1980 to $1.30 per pound this year. That means our growers are getting one-third less money for their product, a disaster from their standpoint. But the British buyer, because of the grossly overvalued dollar/undervalued pound, is paying 56 percent more for our $1.30 product than he did for our $1.88 product in 1980. The French buyer is paying 78 percent more, and the German buyer is paying 35 percent more. Think about that. Our growers are getting one-third less, but our buyers are paying about 50 percent more. All of this is a result of the dollar relationship with other currencies, and nothing more.

Almond growers have adjusted to the grossly overvalued dollar by taking one-third less for their product. Many others in agriculture have done the same thing. But neither almond growers nor the growers of other crops, whether it be grapes, cotton, wheat, or soybeans, can continue to operate year after year receiving less than the cost of production. The dollar must be brought down to a more reasonable level, or agriculture, as we know it today, will not survive.

This prospect should not be taken lightly. Approximately one-third of all the agricultural land in this country is planted for export. This is true on a national basis, as well as here in California. For many crops, such as wheat, soybeans, almonds, rice and cotton, more than half of the crop must be exported. A recent USDA study shows that more than one out of every five jobs in the United States has its roots on the farm. More than 22.7 million Americans -- 22 percent of the work force -- earn their living in agriculture.

I have told you how agriculture is trying to adjust to the grossly overvalued dollar. Perhaps we should take a moment and talk abut how others are adjusting.

By mid-year, 1984, two million of the best jobs in this country had been lost. Some industries, and this includes farmers, have made adjustments by simply closing down -- going out of business. They are bankrupt.

Others are adjusting by moving their production out of this country and into areas where there is a weak currency. The great Caterpillar Tractor Company and John Deere are two examples. The distortions created by the grossly overvalued dollar have forced them to produce their products overseas, rather than in the heartland of America. Caterpillar has cut its work force from 90,000 in 1979 to 60,000 today. This year, Caterpillar is consolidating its production of truck-type loaders -- which have been made in both Davenport, Iowa and Glasgow, Scotland -- in Glasgow, not in Davenport. Next year, Caterpillar is going to start production of its D-6 tractor in Grenoble, France, laying off still more workers in Davenport, Iowa.

Chrysler and General Motors are not only importing finished cars at cheap prices, but are also importing more and more of the components they put in their so-called "American car". Chrysler has cancelled their plan to build a new U.S. plant, which would have been worth billions and tens of thousands of jobs. They will do it overseas instead. Boeing is having difficulty competing with the Airbus. Recently, our largest international carrier, Pan Am, purchased the Airbus rather than a domestic product. Boeing is trying to adjust by buying more and more of the components they put in each finished Boeing aircraft from overseas suppliers.

At our own Blue Diamond facility in Sacramento, we have learned that a piece of packaging equipment that we formerly purchased from the manufacturer in Sheboygan, Wisconsin, for about $100,000 can be purchased from the Wisconsin manufacturer's Italian subsidiary for about $50,000. With the plight our farmers are in, where do you think we are purchasing that equipment?

We have also found that we can buy packaging material, like cellophane and foil, at about half the U.S. price from manufacturers in the United Kingdom or Brazil. We, too, are beginning to do some packing overseas.

Sun-Diamond, a major California cooperative, is moving a great deal of their processing from Stockton, California, to Tijuana, Mexico. Tri-Valley, California's largest canner, is considering doing some of its fruit processing in Japan.

And the list goes on and on. Two million jobs have already been lost in this country and the number is climbing rapidly.

This country has been known around the world as the most efficient world grain producer. Yet a few months ago, Cargill, this country's number one grain trader, found that they could land grain from Argentina in the United States cheaper than they could get it here in this country. A spokesman for USDA, commenting on this situation, said, "When the river starts to flow backwards, there is something wrong with the plumbing." The "plumbing" problem, if you will, is the grossly overvalued dollar.

The same is true in my favorite food -- almonds. California is the world's most efficient producer, we are highly mechanized, we have harnessed the water in the mountains to our advantage and we use all the most modern cultural practices. We out-produce our next largest competitor, Spain, at the rate of 10 times as many almonds per acre, producing 1,500 shelled pounds per acre versus an average of about 150 pounds per acre in Spain. But, because of the horrible distortions in the dollar/peseta relationship, growers are removing almonds from production in California, while growers are planting in Spain.

If these alarming trends continue, and I see every indication that they will, the day will soon come when this country will be unable to export anything. Our prices will simply be too high.

Some might argue that our industries can still depend on the domestic market. That would be a good idea except that our prices will be too high here as well. As a result of the dollar relationship with other currencies, imported products can come in much more cheaply than we can produce them at home. That is why there has been a five-fold increase in imports in just the last four years.

What sort of an economy will we have if we can neither export what we produce, nor sell it here at home? I submit, we will not have any economy. We will be bankrupt as a nation.

Some people say we will be a service economy. If we do not have an agricultural industry, a tourism industry (foreigners cannot afford to come here, and Americans are finding it cheaper to vacation abroad), an automobile industry, a steel industry, a machine tool industry, an aircraft industry, an appliance industry, a TV industry, and a photographic industry, who are we going to be servicing? Our computer hardware and software cannot be expected to service the rest of the world. Some people say we will become a McDonald's economy. But, I ask, where are people going to get the income to buy those Big Mac's?

It should now be clear that something must be done to correct the grossly overvalued dollar. What, then, should be done?

Before answering that question, I would like to take a moment to explain why the dollar today has such an extremely high value in the world. There are two basic reasons. Number one, the United States is considered a "safe-harbor" for overseas investors -- the safest harbor in the world. No other country in the world, in the view of the world, is less likely to suffer from a civil war, insurrection, overthrow by a foreign power, or any other major destabilizing event. The United States is the very best place you can invest your funds and not have any fear of losing them due to some unpredictable event. We are fortunate to live in such a great country. The world perception of this country as a safe harbor is not something any one of us would suggest should be changed.

The second reason for the strength of the dollar is the very high real interest rates currently being paid in this country. While nominal interest rates, the amount a big borrower pays for money, have come down from about 21 percent to the 11 percent range, the real interest rates, the difference between the rate of inflation and the nominal interest rates, or prime rates, are at an all-time high. This means that a foreign investor not only receives security and safety, he also enjoys the highest real interest rates in the world.

If we were in fact in the business of packaging investment opportunities for foreigners, we would either offer them high rates with little safety or low rates with a great deal of safety. We offer both. This has produced the influx into this country of foreign money, bolstering the dollar to new records relative to other major currencies.

It is our government that is responsible for the dollar's high value. In this environment, where too many people are trying to borrow too few dollars, the United States has been the biggest borrower of all. Real interest rates -- in accordance with basic principles of supply and demand -- are thus held at an all-time high.

In just three years, the United States has changed from the world's largest creditor nation to the world's largest debtor nation. A few years ago, Americans owned about $150 billion more abroad than foreigners owned in the United States. Now, we borrow $100 billion and more abroad to finance our national debt. During this year, the U.S. foreign debt will exceed that of Brazil and Mexico, places we formerly complained about as the world's largest debtors.

In 1974, just 11 years ago, people were alarmed that our annual federal budget had a deficit of just over $6 billion. Today, that number has grown by a factor of 33 times to more than $200 billion annually.

In 1974, again just 11 years ago, people were also alarmed by the debt that our federal government had accumulated in the first 198 years of our history -- $486 billion. In the six years that followed, we managed to double that debt again to $914 billion. And by the end of this year, five years later, we will have doubled the $914 billion debt to $1 trillion, 807 million. This projection is probably understated, since it assumes a deficit this year of $190 billion when it is likely to be closer to $222 billion.

One of the problems we have with all these numbers is that none of us can visualize what a $222 billion deficit really is. Perhaps I can put it in perspective by asking you to think of this year's $222 billion federal deficit in some other terms. For example, the total number of seconds from the time Christ walked the earth until today is only 63 billion. The entire area of the earth's surface is a miniscule 197 million square miles -- 1/11th of a billion, compared to 222 billion.

This year, $131 billion, or 14 percent, of the total outlays by our federal government, will be interest on the national debt. Put another way, 69 percent of our deficit will be interest on the national debt. Last year it was 59 percent, and the year before that it was 45 percent. Again, a very alarming trend.

Our problem, ladies and gentlemen, is that the budget proposed by the President for fiscal 1986 reduces the budget deficit by only about $40 billion -- chicken feed when one talks about federal budgets.

The Senate talks in terms of a $60 billion reduction in the annual deficit. At the rate they are going in approving the continuation of various programs, there will be no reduction at all.

The President says we cannot touch defense and social security. Add those two together and then add in the interest on the national debt, something we cannot avoid until we have massive reductions on that debt, and it adds up to about $580 billion out of a $977 billion annual budget.

Given that these untouchable programs plus the interest on the national debt amount to 60 percent of our total federal outlays, can we realistically expect to get the necessary cuts from the 40 percent that is left? The cuts could be made from the farm programs, but that would only run about $10 billion to $12 billion a year. Similarly, they could come from Medicare or the Federal Highway Program, but when you get through cuts in all these programs, they are not enough to reduce the deficit by $50 to $60 billion this year, and more in the next few years.

The answer, then, is more revenue. The President, however, has rejected this approach and was able to use this view successfully as part of his platform for reelection last year.

The Democrats, too, are unwilling to propose a tax increase, since they lost the election in part because of Mr. Mondale's tax increase proposal.

All this adds up to a grim and perhaps hopeless situation, unless the American people speak out and demand action. A call should be made for across-the-board cuts in every single category of federal spending. Farm programs, social security, Medicare, defense, student loans, Small Business Administration programs, and every other program must be affected. The only way to bring about massive reductions in federal spending is to spread the cuts in a fair and equitable way over each person, interest group, and sector of the economy. No one should be spared except the absolutely destitute and those absolutely unable to help themselves.

Unfortunately, even if these cuts are made, we will still find ourselves short of our goal of a $50 to $60 billion reduction in the deficit in the next fiscal year, with greater reductions in the years following. We need, as a realistic goal, a balanced federal budget in four to six years. That simply cannot be attained with cuts in expenditures alone. More revenue is needed. This means a broadening of the tax base, a change in income tax rates, or perhaps a new form of tax for this country, such as a consumption tax or a value added tax.

Time is running out. Next year is an election year. I know we just finished an election, but next year is another one. If action is not taken to obtain massive reductions in the deficit by mid-year, I am afraid our Congressmen are going to be too busy with their reelection to deal with the very tough decisions that massive deficit reductions will entail.

Drastic action by our federal government is needed now. The huge federal deficit has forced our dollar to an all-time high, making it impossible for us to sell our goods both abroad and at home. Two million American jobs have been lost since 1980. In steel, we have gone from 13.8 percent imported product in 1970 to 25 percent last year. In autos, we have gone from 15.2 percent imported product in 1970 to 23 percent in 1984, and that was with a voluntary auto import quota in place. In machine tools, we have gone from 9 1/2 percent imported product in 1970 to a staggering 41 1/2 percent in 1984. In wine, we imported 11 percent in 1970 (principally premium wines), doubled that in 1980, and by 1984 had increased our imports (now primarily bulk wine) to a whopping 26 percent. California wine producers can hardly buy the bottles and labels, let alone buy the grapes, produce the wine, and ship it for the price that many foreign producers are delivering their wine for in this country. As a result, consumption of U.S. produced wines has increased only 8 percent in the last four years, while consumption of foreign wines has increased 39 percent, nearly five times the growth of our own product.

What I have been talking about today is not a problem specific to agriculture, but rather a problem for this entire nation, for its industry and for its agriculture. It is a problem that must be solved if this nation is to remain economically viable. America, agriculture, the other industries I have mentioned, and many others I have not mentioned are in grave danger of extinction unless the dollar is brought down to more reasonable values. This is the major problem facing our nation.

If we do not bring about massive reductions in the federal deficit beginning with fiscal year 1986 and continuing for a number of years after that, I fear it may be too late. Four more years will have passed, a new Presidential election will have taken place, there will be many new faces in Congress, and industry and agriculture, as we have known it in the United States, will be a memory for all but a very, very few.

Written Submission of Eugene L. Stewart, Esq.
Executive Secretary & General Counsel
Trade Relations Council of the United States, Inc.
To the Senate Finance Committee
Concerning the April 23-24 Hearings
on Floating Exchange Rates'
Impact on International Trading

When the dollar was cut loose from gold in 1971 and the floating exchange rate system was later accepted by the Congress and the Executive Branch, a fundamental error was made in the approach to international trade here in the United States and by our allies abroad. The modification in the approach to adjusting exchange rates was not coupled with any modifications to other elements of the trading system to maintain predictability or provide for the orderly growth and contraction of industries within an economy. The result has been the creation of exaggerated artificial comparative advantages, constraints placed on industries' ability to anticipate change, and resort to a series of non-tariff practices to provide the control that the move to floating exchange rates without modification of the trading system had eliminated.

This paper briefly reviews the importance of exchange rate predictability as viewed historically, the failure of the Government to modify its trade policy to compensate for the move to floating exchange rates in 1971, and the extent of overvaluation. Separately submitted is preliminary summary data from a soon-to-be-released study* of the U.S. economy which demonstrates the hardship that has befallen many U.S. industries

* Because of its size, retained in Senate Committee on Finance files.

as the floating exchange rate system has generated dollar values, particularly in recent years, out of line with the purchasing power parity rates of our trading partners.

1. The international stabilization of currencies was an essential element in the post-depression international trade system.

As the Committee is well aware,* when the Bretton Woods system was put in place, a central concern was to reestablish an exchange rate system that could be fixed, though adjustable, to permit countries to devalue when the currency was in "fundamental disequilibrium," yet provide the market the certainty and predictability that comes from fixed exchange rates that are adjusted only infrequently. *See generally* T. de Saint Phalle, *Trade, Inflation, and the Dollar* at 102-07 (1981); J. Jackson, *World Trade and the Law of GATT* at 9 (1969); 89 Cong. Rec. SA1671 (daily ed. April 7, 1943)(reprint of statement of Sec. of Treasury: "We feel that international currency stability is essential to reconstruction in the post-war period and to the resumption of private trade and finance."); 89 Cong. Rec. HA1987 (daily ed. April 21, 1943)(statement of Rep. Ford); S. Rep. No. 452, 79th Cong., 1st Sess. 1-4, 7-8, 10, 28 (1945).

The Bretton Woods program was a response to the international currency and investment experience of the late 1920's and the 1930's and the termination of the "gold" standard. During this period of monetary crisis, international trade declined because businesses were unable to calculate foreign exchange risks; currency devaluation wars occurred as one country would devalue its currency to eliminate the perceived competitive advantage that would flow from another country's currency depreciation; and export controls, import quotas, as well as tariffs, were extensively used to provide some control in the marketplace. E.g., H.R. Rep. No. 406, 76th Cong., 1st Sess. 2, 7, 9, 10 (1939); S. Rep. No. 591, 96th Cong., 1st Sess. 2, 3, 6 (1939)("Within the past 5 years over 50 nations have changed the value of their currencies. . . . Furthermore, there is no guaranty that other countries will not again depreciate their currencies in order to acquire for themselves a larger share of world trade. . . . That depreciation of its currency by a leading foreign economic nation is detrimental to American industries producing for domestic or export consumption which compete with foreign producers becomes apparent upon examination of the situation in 1932.")

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* The Finance Committee Staff has prepared a memorandum in connection with the Committee's hearings on "The Role of Floating Exchange Rates in the International Trading System" (dated April 22, 1985)[hereinafter "Senate Finance Committee Staff Memorandum"] which reviews, *inter alia*, the history of Bretton Woods.

2. Floating exchange rates can result in the impairment of benefits flowing from multilateral trade agreements, arguably without recourse; yet Congress in 1974, 1979 and again in 1984 has failed to address this important defect in existing trade policy.

The GATT system, with its bindings or commitments in the tariff reduction area and requirement of MFN treatment, loses its mutuality of opportunity and becomes overburdensome on certain countries when exchange rate movements deviate from fundamental economic conditions within the country.* For example, when the United States and Japan (among others) agreed to a roughly sixty percent reduction in duty rates in 1979 during the so-called "Tokyo Round" of trade negotiations, no specific mechanism was provided by the Congress, or included within the trade agreements, to cope with movements of the exchange rates (beyond changes in comparative inflation rates) which could in fact nullify the benefit** supposedly to be received by the United States or which could result in effective increases in duty reductions beyond those authorized by the Congress in the enabling statute. Yet, as history has shown, the system of flexible exchange rates has resulted, particularly in the last three years, in a total nullification of the benefits to be received by the United States, not just from Japan but from many of our other trading partners as well. The U.S. has confronted an increase in trade barriers on its exports (which can be viewed as either an increase in effective tariff rates in Japan and many of our other trading partners or as an

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* On the objectives of trade negotiations under the auspices of GATT, see generally J. Jackson, World Trade and the Law of GATT at 240-41 (1969)["There are three major premises underlying present procedures for trade negotiations in GATT: (1) that they will be 'reciprocal and mutually advantageous'; (2) that results will be generalized through MFN; and (3) that concessions will be protected from at least some nontariff barriers by the general provisions of GATT."]

** Article XXIII of the GATT deals with "Nullification or Impairment" of benefits and presents an apparent cause of action for the United States to take to cope with the serious overvaluation of the dollar. Article XXIII states in part:

> 1. If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of
>
> (a) the failure of another contracting party to carry out its obligations under this Agreement, or
>
> (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or
>
> (c) the existence of any other situation,
>
> the contracting party may, with a view to the satisfactory adjustment of the matter, make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it.

[footnote from previous page continued]

GATT, BISD Vol. IV at 39-40 (1969).

Whether Article XXIII deals affirmatively with the floating exchange rate difficulties imposed on the United States in the last few years has not to date been tested. Prior case law under GATT on Article XXIII suggests that nonviolation nullifications are actionable only if the subsequent events could not reasonably have been anticipated. The Australian Subsidy on Ammonian Sulphate, GATT Doc. No. CP. 4/39 (Apr. 3, 1959). See R.E. Hudec, "Regulation of Domestic Subsidies Under the MTN Subsidies Code," Interface Three: Legal Treatment of Domestic Subsidies at 1, 2-8 (1984). By 1979, it is at least arguable that the United States should have been able reasonably to anticipate that dramatic swings in exchange rates could occur that would be divorced from underlying economic phenomena within a particular country.

Article XII of GATT ("Restrictions to Safeguard the Balance of Payments") is a vehicle which permits temporary action to correct balance of payments difficulties in certain circumstances. While Article XII provides the legal justification for import limitations [including a surcharge (see, e.g., in these hearings, Statement of Robert W. Galvin, Chairman of the Board and Chief Executive Officer, Motorola, Inc., Attachment 2 (April 24, 1985)); Senate Finance Committee Staff Memorandum at 27-28], it was conceived in a time when exchange rates were fixed and operates in a context which does not recognize the nullification of benefits to a signatory and hence potentially subjects the country to retaliation if the action taken is not deemed consistent with the requirements of Article XII.

export tax imposed by virtue of the value of the U.S. currency) and the total elimination of tariffs, plus the provision of price subsidies, on its imports. As recognized nearly fifty years ago by then Director of Monetary Research at the Treasury Department, Harry Dexter White, in talking about the effects of a foreign country's devaluation on U.S. imported merchandise:

> It is just as though you cut the tariff, except that you are cutting more than a proportion of the tariff, because it is very frequently an ad valorem rate, and therefore if you were to reduce a foreign currency by, let us say, 30 percent . . . then it might be equivalent to a cut on a 50 percent duty of, not 30 percent but from 50 to 100 percent, depending upon the basis of comparison and upon the extent to which the American importer gets the full advantage.

Devaluation of the Dollar and Stabilization Fund, Hearings Before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 1st Sess. 152-153 (1939).

The essential nullification of the U.S. trading benefits has been recognized, at least with respect to Japan, by the members of this Committee and nearly all other members of the Senate, although the focus of the nullification concerns was on the limitations of access to the Japanese market. As stated in Sen. Con. Res. 15, "the high value of the dollar relative to the yen effectively subsidizes Japanese exports to the United States and taxes United States exports to Japan." See also 131 Cong. Rec. H1769 - 1816 (daily ed. April 2, 1985) (re H. Con. Res. 107). See also Testimony of Colby H. Chander, Chairman and Chief Executive Officer, Eastman Kodak Company, before the Senate Finance Committee, at 6 (April 23, 1985).

Despite the now 13-year history of floating exchange rates and the apparent recognition by the Congress of the serious adverse consequences that flow from such currency systems to the domestic economy, its industries and workers, the Congress has not modified the ground rules for U.S. participation in multilateral trade arrangements and has not, with one exception, modified any of the statutory avenues of relief for adversely affected domestic industries to eliminate or offset the recognized harm. Yet there have been at least three major revisions in U.S. trade laws: the Trade Act of 1974 [Pub. L. 93-618]; the Trade Agreements Act of 1979 [Pub. L. 96-39]; and the Trade and Tariff Act of 1984 [Pub. L. 98-573].

In the 1974 Act, Congress provided an avenue which appeared to require the Executive Branch affirmatively to deal with trade distortions flowing from floating exchange rates. Section 122 of the Act (19 U.S.C. § 2132) states:

> (a) Whenever fundamental international payments problems require special import measures to restrict imports--
>
> (1) to deal with large and serious United States balance-of-payments deficits,
>
> (2) to prevent an imminent and significant depreciation of the dollar in foreign exchange markets, or
>
> (3) to cooperate with other countries in correcting an international balance-of-payments disequilibrium,
>
> the President shall proclaim, for a period not exceeding 150 days (unless such period is extended by Act of Congress)--
>
> (A) a temporary import surcharge, not to exceed 15 percent ad valorem, in the form of duties (in addition to those already imposed, if any) on articles imported into the United States;

> (B) temporary limitations through the use of quotas on the importation of articles into the United States; or
>
> (C) both a temporary import surcharge described in subparagraph (A) and temporary limitations described in subparagraph (B).

This authority can be exercised against one or more countries where the major balance of payment problems are with those countries. 19 U.S.C. § 2132(d)(2). Despite admittedly very large and serious balance of payments problems in recent years [See, e.g., Economic Report of the President (Transmitted to the Congress February 1985) at 344-45; Subcomm. on Int'l Trade, Investment and Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs, Foreign Exchange Value of the Dollar at 4, 10 (1984)(Comm. Print 98-12)], the President has taken no action under section 122. Indeed the section has never been utilized nor, to my knowledge, have the consultation provisions of section 122(b) ever been invoked.

This inaction, coupled with the number of surcharge bills which have been recently introduced in Congress [e.g., H.R. 1139, S. 761, S. 770 and S. 906], suggest a perception by the Executive Branch and the Congress that section 122 is not designed to cope with the difficulties caused by the rise in the value of the U.S. dollar.

The Congress did not provide any other vehicle for preventing or stopping the harm caused by significant swings in currency value in any of the three trade bills or in other legislation. Remedies such as the escape clause have either been interpreted quite narrowly, making their usefulness highly questionable until grave injury has been suffered, or have been interpreted in a light which suggests that exchange rate movements could defeat entitlement to relief altogether! See, e.g., Stainless Steel and Alloy Tool Steel: Report to the President on Investigation No. TA-201-48 Under Section 201 of the Trade Act of 1974, USITC Pub. 1377 at 36-37 (May 1983) (views of [then] Commissioner Stern) ("The high interest rates are without any doubt a major reason for the overvaluation of the U.S. dollar in the exchange markets, and this overvaluation, along with other factors, has led to the decline in exports from the United States. . . . [T]he decline in U.S. exports was also a more important cause of injury than imports and was perhaps as significant as the exceptional decline in demand.").

3. A measure of the extent of the overvaluation of the dollar in 1982-84 resulting from exchange rate movements

While the cause or causes of the overvaluation of the dollar have received considerable focus, but little consensus,

> No one disputes the simple facts of dollar appreciation. According to Chairman Feldstein, "Since 1980, the exchange value of the dollar has increased nearly 50 percent relative to the other major currencies of the world after adjusting for differences in inflation." Other measures of dollar strength reveal the same broad picture: to a degree no one anticipated and no one can fully explain, the dollar began, about mid-1980, an unprecedented, sustained real appreciation that has deeply undercut the competitiveness of our export and import-competing industries. No witness doubted that this real appreciation is a major proximate cause of our sharply rising trade deficit, or that it severely damages firms producing traded goods. Chairman Feldstein: "It is the rise in the real exchange rate of the dollar relative to the other major currencies of the world that is the primary reason for the substantial trade deficits that the

> American economy is now experiencing. . . . These trade deficits reflect a substantial decline in U.S. exports and a large rise in U.S. imports. Both of these trends are doing very substantial damage to major segments of American industry." Under Secretary Sprinkel: "There is no question that dollar appreciation has made imported products highly competitive with domestic production. And there is no question that U.S. products have lost competitiveness in international markets over the last four years."

Subcomm. on Int'l Trade, Investment and Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs, Foreign Exchange Value of the Dollar at 1 (1984)(Comm. Print 98-12).

While the above quoted material reflects the reality that many of our major trading partners' currencies have been seriously undervalued vis-a-vis the dollar during the past four years (or the dollar overvalued), these comments will focus on Japan. There have been a series of hearings in the past several years that have specifically examined what a fair conversion rate for the yen into dollars would be. Excerpts from some of these hearings are included below:

> My bottom line on what needs to be done is identical to Mr. Elder's: The yen rate must strengthen to somewhere between 180 and 200 to the dollar and it must do so quickly. Most Japanese, as he said, agree that the yen needs to rise. Some would say 210 is enough, or 220 is enough, but everybody agrees that it needs to rise.

Current Exchange Rate Relationship of the U.S. Dollar and the Japanese Yen, Hearing before the Subcomm. on Trade of the House Comm. on Ways and Means, 97th Cong., 2d Sess. 11 (1982) (statement of C. Fred Bergsten, Director, Institute for International Economics).

> I would say, Mr. Chairman, having talked to perhaps 30 different important people in Japan, including press, academics, business people,

> government people, the range of values on a trade competitive basis now are agreed within Japan to be somewhere between 180 and 210 to the dollar versus what we have had recently, 250 to 275.

Id. at 34 (statement of Peter G. Peterson, Chairman of the Board, Lehman Brothers Kuhn Loeb Inc.).

> First, we should clarify -- to ourselves and to the Japanese -- that correction of the currency misalignment is the cardinal policy objective for the foreseeable future -- indeed, until the yen strengthens to perhaps at least 200:1 against the dollar.

Id. at 53.

> Well, the problem today is that the rates are simply misaligned. It is not that they vary too much. They are simply misaligned, and a rate of the dollar to the yen, which by most calculations of purchasing power parity or any rational theory ought to be around 180 or possibly 200 or even 210, whatever you want, something in the range of 185 to 200, has recently been as high as 275.

Id. at 108 (statement of Lawrence A. Fox, Vice President for International Economic Affairs, National Association of Manufacturers).

> MR. PEASE. We heard this morning private witnesses say that they thought the exchange rate for the yen ought to be somewhere between 180 and 200 to the dollar. What would you put the figure at?
>
> MR. NISKANEN [Member, Council of Economic Advisors]. The calculations which we made suggest that the purchasing power parity natural rate at the moment would be around 220. The allegations or assertions that have been made that the appropriate exchange rate is in the 180 to 200 range I think are not consistent with what happened at a time when the yen was that strong.
>
> In the year or two following that very strong yen, the Japanese had a big current account deficit, and that is the best indication that the yen at that time was unusually strong rather than at its natural rate.

Id. at 170-71.

> There is an urgent need for the United States and Japan to declare publicly their intention to solve the problem and work out a joint program to bring the yen-dollar rate to 200:1 or less as quickly as possible, from the current level of about 240:1, through some combinations of the steps mentioned here.

U.S. Economic Relations with Japan, Hearing before the Senate Comm. on Foreign Relations, 98th Cong., 1st Sess. 29 (1983) (statement of C. Fred Bergsten, Director, Institute for International Economics).

We agree with the views expressed above that the dollar has been overvalued vis-a-vis the yen by considerable amounts during recent years. Our method of estimating the degree of overvaluation is predicated upon three assumptions: (1) that at some period prior to 1980, the exchange rate between the yen and dollar roughly reflected the purchasing power of the two currencies ("purchasing power parity"); (2) the extent of exchange rate appreciation (or depreciation) that exceeds the difference in inflation rates creates a competitive disadvantage (advantage) that is not connected with the underlying strength of the domestic industries producing the goods, but rather with conditions beyond the industries' control (e.g., national monetary policy, interest rate differentials, political stability, speculation); (3) Congress does not intend to penalize domestic industries or their workers where the comparative advantage of foreign goods is due to the conditions identified in (2).

The second assumption reflects common sense: if in year 1, the wholesale price of a loaf of bread is Y300 in Japan and $1 in the United States, an exchange rate of Y300/$1 represents parity of purchasing power (this hypothetical picks a product assumed to be "typical" of the national cost/efficiency profile). If by year 5, the wholesale price of a loaf of bread has risen to Y400 in Japan and to $2 in the United States, an exchange rate of Y200/$1 represents the revised parity of purchasing power, reflecting the differences in wholesale price increases (which in turn reflect differences in productivity, wage pressures, raw material costs, and the like). To the extent that the exchange rate in year 5 provides fewer yen to the dollar than 200 (e.g., Y185/$1), the U.S. product (and hence the U.S. industry) has a competitive advantage that has nothing to do with the industry's own efficiency or cost structure. Similarly, to the extent that the yen/dollar exchange provides more yen than 200, the U.S. product and industry face a disadvantage that has nothing to do with its own efficiency or cost structure but rather is caused by an exchange rate mechanism which is not coordinated with parity of purchasing power. See, e.g., Paine Webber, "The Dollar: Boom, Bust or Soft Landing," p. 2 (April 9, 1985).

Such "advantages" or "disadvantages" are present in a fixed exchange rate system as well, with equilibrium (from a purchasing parity perspective) being regained only infrequently at a devaluation or appreciation. However, the extent of bias for industrialized countries tends to be more readily predictable because of more comparable levels of inflation and less severe in any given year than the value swings possible under floating exchange rates.

The Table and Chart on the following pages present the actual exchange rates for the yen/dollar during the period 1978 - 1984, based upon figures reported by the Federal Reserve Board. In addition, data on purchasing power parity exchange rates are presented using 1978 and 1981 as benchmark exchange rates.

The year 1978 was selected as representative of purchasing power parity because of the continued strong surplus in the Japanese current account balance and trade balance despite the healthy value of the yen. E.g., Economic Report of the President (January 1979) at 303; (February 1982) at 353. Moreover, 1978 was the last year for which full data would have been available to the Congress and the Executive Branch during the concluding negotiations on the Tokyo Round of Trade Negotiations. Presumably, the concessions to be made by the United States during the negotiations would have taken into consideration competitive conditions in Japan, especially in light of the Industry Sector Advisory Committee (ISAC) program used in the Tokyo Round to provide industry input.

A second year, 1981, was selected for purposes of comparison as it represents the lowest annual exchange rate before the sharp increase in value of the dollar in 1982-84.

Yen/Dollar Comparison Table

1978 Benchmark

Year	Official Exchange Rate	Purchasing Power Parity Rate	Difference in Yen	in %
1978	208.33	-	-	-
1979	218.18	195.60	22.58	11.54
1980	225.68	193.24	32.44	16.79
1981	220.11	188.52	31.59	16.76
1982	249.06	173.28	75.78	43.73
1983	237.55	173.62	63.93	36.82
1984	237.45	165.30	72.15	43.65

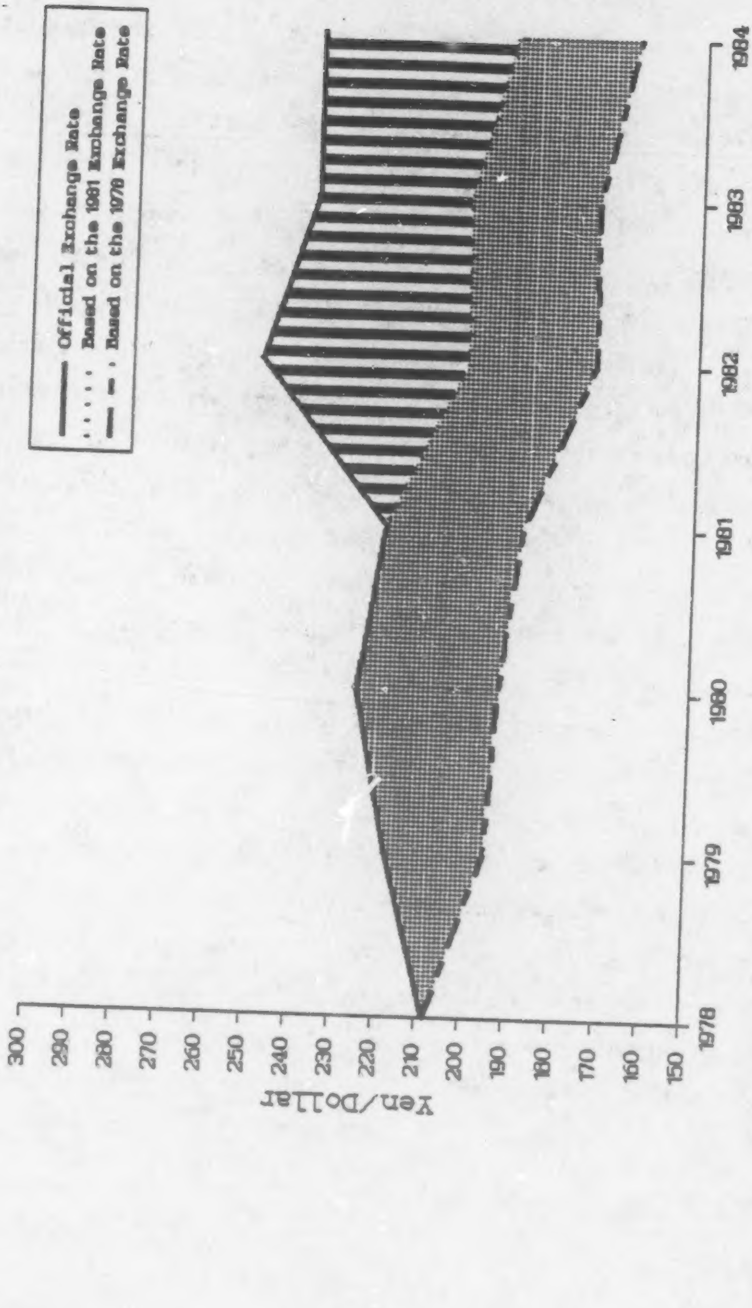
1981 Benchmark

Year	Official Exchange Rate	Purchasing Power Parity Rate	Difference in Yen	in %
1981	220.11	-	-	-
1982	249.06	202.32	46.74	23.10
1983	237.55	202.72	34.83	17.18
1984	237.45	193.00	44.45	23.03

Sources: Federal Reserve Bulletin, U.S. Federal Reserve System; Japan Statistical Yearbook, Prime Minister's Office; Survey of Current Business, U.S. Department of Commerce

Comparison Yen/Dollar Exchange Rate

Actual vs. Purchasing Power Parity Rate
Using 1978 and 1981 as Parity Benchmarks



As the chart and table make obvious, the dollar has exceeded its purchasing parity with the yen by roughly 40% during the last three years. When it is recalled that all U.S. manufacturing corporations averaged net profits before tax (as a percent of sales) of only 4.1% - 8.1% during the thirteen quarters between 3Qtr 1981 and 3Qtr 1984 [Federal Trade Commission (and more recently U.S. Department of Commerce), Quarterly Financial Report for Manufacturing, Mining and Trade Corporations (various issues)], the fact that U.S. industry is being seriously harmed becomes self-evident. Such a skewing of the competitive environment leads companies to forego or postpone investments in the United States, strips U.S. companies of the profits necessary from existing U.S. investments to remain technologically competitive, and sows the seeds for worldwide excess capacity in industries benefiting from investment incentives artificially created through temporary exchange rate advantages. See, e.g., Testimony of Lawrence A. Fox, Vice President, International Economic Affairs, National Association of Manufacturers on The Dollar Exchange Rate and the U.S. Trade Deficit, Before the Senate Finance Committee ["NAM Statement"] at 2-6 (April 24, 1985). Finally and critically, the skewing of the competitive environment forces down the wages of workers to permit some minimal survival of industries suffering injury from misaligned exchange rates. This condition is reminiscent of the economic environment of the late 1920's and 1930's when the world passed quickly into massive depression (one of the heaviest burdens of floating exchange rate skewing falls on the individual worker.) Many workers in the United States today have gone from earning a decent living (and being competitive internationally at an exchange rate close to purchasing power parity) to enduring a lower standard of living despite increased productivity when floating exchange rates have diverged from purchasing power parity in the last four years.

If U.S. industries and their workers are not to be sacrificed needlessly, any remedy, or combination of remedies, chosen by the Congress must address this fundamental divergence of exchange rates from any likely purchasing power parity level. Modification of the section 201 "escape clause" provision to ensure that movements in exchange rates that encourage increased imports constitute a basis for granting temporary import relief, imposition of temporary quotas, a tariff surcharge (sliding in response to movement of the exchange-rate) against Japan alone or Japan and a few other key countries, establishment of guidelines for automatic review by the Executive Branch of the advisability of employing section 122 of the Trade Act, increased EXIM Bank financing during periods of overvaluation of the dollar, as well as the many monetary and other recommendations that others have presented to this Committee on April 23rd and 24th [e.g., NAM Statement at 10-14; Testimony of Rudolph A. Oswald, Director, Department of Economic Research, American Federation of Labor and Congress of Industrial Organizations at 5-12 (April 24, 1985); Statement of Gary Clyde Hufbauer, Senior

Fellow, Institute for International Economics at 13-14 (April 23, 1985)], are all possible options.

4. Summary of the TRC Study: Statistical Review of the Impact on Domestic Industries.

The separate TRC summary provided to the Committee presents a computer compilation of all public data felt to be relevant to the economic growth and foreign trade of U.S. manufacturing industries. The statistical compilation was prepared by the Trade Relations Council as a service to its members, to U.S. manufacturing industries generally, to the Congress, to the Executive Departments of the U.S. Government and to all who have an interest in the impact of foreign trade on employment, output, and growth of U.S. manufacturing industries.

The summary data submitted consist of part of the data compiled on the two digit SIC industry groups, including total figures for total manufacturing, total durables and total nondurables. Import and export data for the total groupings are presented two ways: landed cost duty paid/f.o.b. mill (est. at 90% of reported official export statistics); and f.o.b. foreign port/f.a.s. U.S. port. Import and export statistics for the other two digit industries are presented only on a landed cost duty paid/f.o.b. U.S. mill basis in this special preliminary summary report.

Domestic industry data are only available through 1982. Foreign trade statistics are available through calendar year 1984. The charts included with each two-digit industry data series graphically display the dramatic worsening of the U.S. trade balance in recent years as well as the coincidence of that worsening with the appreciation of the dollar.

We would be pleased to provide the Committee or its Staff with any supplemental or clarifying information desired.

Respectfully submitted,

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The Dollar's Borrowed Strength

(By Otmar Emminger, former President of the Deutsche Bundesbank)

I. INTRODUCTION AND SUMMARY

This essay is based on a speech given in New York on January 30, 1985, shortly before the dollar reached its (preliminary) peak of Dmark 3.47 on February 26, 1985. It cannot be excluded that by the time this essay appears in print, the dollar may no longer be flying high, or even have turned around toward some decline. But it is very likely that it will remain "strong"—in the sense that its exchange rate in relation to other major currencies will remain far above its relative purchasing power parity, however calculated. Even if the dollar's strength should have lost its momentum, it will still be of interest to consider how this strange distortion in the world's currency system—which the London "Times" has recently elevated to the rank of an "exchange rate crisis"—has come about, and what its effects have been. These are the two main questions I am going to deal with. I shall round this off by a brief glance at the future prospects of the dollar—inevitably a very tentative view for the short run, but a more certain one for the longer run.

Over recent years the exchange rate of the dollar has become by far the most important price in the world economy (while ten years ago this role would have been attributed to the oil price). Especially at its present distorted value, it has an enormous impact both on the American economy and on the rest of the world. The overly high dollar is changing—some would say distorting—the structure of world trade and of major economies, beginning with the American economy. It is itself the result of a staggering shift in the regional structure of international capital movements with the result that the United States, the richest country in the world, is now attracting capital imports which, on a net basis, are much more than double the total capital imports into the Third World, and is financing about a quarter of its total capital needs from foreign sources. Taking all together, it is the largest imbalance the world economy has seen for a long time.

My thesis will be that, contrary to some official views on both sides of the Atlantic, the impact of the high dollar has been, on balance, rather favourable for the Europeans—despite some inherent risks and dangers—while the negative effects are falling increasingly on the American economy. Thus, the high dollar is becoming more and more an American problem.

The prolonged strength of the dollar has not only been the most important, but also the most over-explained—and maybe least understood—economic event of our time. At first sight it is a paradoxical phenomenon: What for every other currency would be a source of weakness—huge budget and trade deficits—seemed to drive the dollar higher and higher. And often the dollar got an upward push in the markets when the American money stock M_1 rose disproportionately for a few weeks. All this tallies perfectly with the definition of a paradox, which according to Webster's Dictionary is "a statement that is seemingly contradictory or opposed to common sense, yet is perhaps true".

A bewildering number of different explanations have been offered for this paradoxical and unique phenomenon. They range from vague political and psychological generalities, like a strong country has a strong currency; the strong dollar is a vote of confidence for the U.S. and against Europe; the political and social stability of the United States attracts money from all over the world (safe-haven motive); the dollar will remain strong as long as Republicans rule in the White House ("Reagan bonus"); there is no real alternative to the dollar for foreign investors, etc.—to a number of very diverse economic explanations, like high interest rates in the United States; the impressive decline of inflation in the United States since 1981; the high profit potential of the American economy in general; the superior performance of the American economy, especially the contrast between the dynamic and flexible American economy and the "sclerotic" European economies; the American tax benefits for profits and new investment; the use of the dollar as the world's main trading and financing currency, which is allegedly creating a growing demand for dollars; the urgent demand for dollars by highly-indebted countries (as if they had surpluses in Dmark or Yen which they could convert into dollars!); or—to use President Reagan's recent explanation—the fact that America's trading partners have not caught up with the U.S. recovery (which places the responsibility for the strong dollar plainly on the "weaker" industrial countries).

There can be no doubt that the overriding influence on the exchange rate of the dollar is capital flows, which have completely overwhelmed the influences of the trade and current account balances. The crucial questions are: who are the chief foreign investors in dollar assets? And what are their main motivations? This is a very wide and complex field.

But before venturing into some nebulous generalities, it is necessary to take a glance at the present composition of the American capital balance. This look at the actual facts shows some astonishing results, which disprove a number of oversimplified onesided explanations. The most important examples are the following:

Between 1982 and 1984, when the American capital balance vis à vis the rest of the world improved by a staggering $90 billion (net),[1] the total inflow of foreign money (gross) into the United States increased hardly at all. The net improvement in the capital balance was practically accounted for by a sharp drop in American private lending abroad (from $108 billion in 1982 to $13 billion in 1984). Only a part of this tremendous drop can be explained by reduced bank lending due to the international debt crisis.

A look at the facts also shows that the high dollar has been supported much more by capital flows from Japan than by those from Europe; and Japan cannot possibly be characterized as suffering from anything similar to "Eurosclerosis" or from a lower economic performance or profit potential than the United States.

Moreover, a factual analysis of the motivations should not overlook the fact that in 1984 the flow of foreign funds into dollar assets was strongly promoted by several actions of the American administration, notably the abolition of the 30 percent withholding tax for foreigners as well as the American-Japanese agreement on the liberalisation of the Japanese capital market. For a foreign observer it is difficult to understand why the American side voluntarily increased the disturbing payments imbalance at a moment when its impact was beginning to fall so heavily on the American economy.

As concerns future prospects, the unbalanced American external position has sometimes been compared to the famous Tower of Pisa: obviously leaning, but unexpectedly stable. But sooner or later, some correction of the extravagant external deficit, and with it of the dollar, will become inevitable. The risk of an abrupt fall of the dollar, with its possible impact on American inflation and interest rates, is becoming a major threat to the American economy, but with its possibly disturbing effects on trade also to the rest of the world. I will try to show that in the case of a turnaround a "soft landing" of the dollar is still more likely than the widely feared "collapse".

II. THE "FUNDAMENTAL FACTORS" AND THE DOLLAR

Over the last few years, most forecasts about the dollar have turned out to be wrong. Even those who strongly believe in dollar strength for general political and psychological reasons, irrespective of interest rate and trade developments, have sometimes got their forecasts wrong. Thus, several U.S. government officials had forecast near the end of 1983 that the dollar had probably reached its peak and was likely to show a moderate decline in 1984. In actual fact, the dollar rose in the course of 1984 by 15 percent against the Dmark and 12 percent against a weighted basket of major currencies.

There are good economic reasons for this unpredictability. The dollar is unpredictable mainly because of its dependence on a multitude of very diverse capital flows, with a variety of motivations—for example foreign purchases of American bonds and shares, direct investment in the United States, investment of official exchange reserves in dollar assets, but also borrowing abroad by American companies, foreign lending by American banks, capital flight from weak countries, changes in the leads and lags of trade payments, and also speculation, with its erratic effects on exchange rates, etc. Paul Volcker once said this dependence of the dollar on a variety of different capital flows makes the dollar trend a "Russian roulette".

Some of the forces behind these capital flows are of a fundamental and longerlasting nature: e.g. large structural differences in interest rates and earnings prospects, or fundamental differences in political and economic stability between the United States and other countries. Thus, it would be wrong to include among the socalled "fundamentals" only the conventional factors, namely inflation differences and trade and current account trends. In the case of the dollar, more than for any other currency, some deepseated influences on capital flows are certainly "fundamentals", too; and at present they are more powerful than the so-called "traditional fundamentals".

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[1] This is an approximation, derived from the deterioration of the American payments deficit on current account from $9 billion in 1982 to nearly $102 billion in 1984. The absolute figures for this deficit (and the corresponding net capital imports) are a little uncertain; but the magnitude of the huge change since 1982 cannot be doubted.

If one takes account of the fundamentals in the American capital balance, one could perhaps say that the high dollar is not "overvalued"—because in a market sense it is not. But that does not alter the fact that the exchange rate of the dollar is "distorted" or misaligned, if measured against cost and price relationships, and that this misalignment has an enormous impact on competitive positions and on trade. The fact that the fundamental factors of the American capital balance have overpowered other fundamental factors is one of the major problems of the present international exchange rate system. The distortion in the competitive positions has become a source of dangerous protectionist pressures. And it is, of course, an anomaly that the wealthiest country in the world is, on a net basis, borrowing abroad on an unprecedented scale.

We sometimes hear that the predominance of capital movements over other fundamentals is a new phenomenon, and that it has made traditional textbook wisdom and former experience obsolete How short are people's memories! Already in the early 1960s the dollar's position was dominated by capital flows for a number of years. At that time America put up the best performance as concerns price stability and ran surpluses in its payments balance on current account. And yet it suffered such great capital outflows and gold losses that in 1963/64 an interest-rate equalization tax on certain capital exports was introduced (and maintained until 1973). There was, however, a fundamental difference from the present situation: In the early 1960s America was the low-interest rate country of the world; today it is a structural high-interest rate country. This has reversed the signs of the problem.

The fact that the exchange rate of the dollar is more dominated by capital movements than that of any other currency puts the dollar in a class by itself. This is reinforced by the unique position of the dollar as the world's chief reserve and intervention currency, and as the dominating currency in the international financial markets. The United States does not have, as a rule, a financing problem for its payments deficits—in contrast to practically all other countries. Therefore the United States can afford—or up to now has believed it can afford—the luxury of a passive balance-of-payments strategy (i.e. of "benign neglect").

All this means that the rules for exchange rate policies, adjustment and financing of payments deficits, and also for intervention in the exchange markets, can be very different for the dollar as compared with all other currencies. The dollar is the only currency for which it can be said with certainty that under conditions of capital mobility it can only function as a fully floating currency; any fixed dollar rate, or even a mere target zone for the dollar, would sooner or later be toppled by the enormous amount of highly liquid and volatile dollar holdings in the world and by irresistible capital flows. As experience has shown, other major currencies can function fairly well in a regional system with firm, but readily adjustable parities, especially when—as in the European Monetary System—the mutual payments relations are determined more by a very large volume of trade and service transactions than by capital transactions.

III. THE DRIVING FORCES BEHIND THE CAPITAL FLOWS

I have already emphasized that the dependence of the dollar on a variety of capital flows makes its future prospects nearly unpredictable. The only thing we can predict with any confidence is that the present payments imbalance and exchange rate distortions are not sustainable for ever. However, nobody can predict when the inevitable turnaround will come. Nor is it as yet foreseeable whether it will be forced upon the United States from abroad—e.g. by a decline of confidence on the part of foreign investors—or whether the United States will itself be lowering its need for foreign funds—e.g. by cutting its budget deficit or by sliding into a recession, with a consequent significant decline in dollar interest rates.

To gain at least some idea about the sustainability (or otherwise) of the present constellation we have to look more closely into what has happened up to now. If we measure the net capital imports of the United States by the payments deficit on current account, we see an increase from $9 billion in 1982 to $42 billion in 1983 and to $102 billion in 1984.[2] What have been the driving forces behind this staggering increase? Are they likely to persist? There are some schools of thought which believe they can give clear-cut answers—very contradictory answers. Some are very optimistic, others very pessimistic for the dollar.

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[2] Even if the current account deficits were actually lower by annual amounts of $10 to $15 billion (because not all invisible income was recorded), the upsurge from 1982 to 1984 would still be staggering

The *dollar pessimists* believe that the dollar is on the brink of collapse because the huge current account deficit is unsustainable, or because American interest rates are bound to go down with the threat of a recession, and above all because a very large part of the capital flows into the dollar is in their view "hot money" and very unreliable.

The dollar optimists believe that the dollar will remain high for a long time to come. In their view its value is mainly determined by confidence in the political and economic stability of the United States and by the superior performance and earning power of its economy. Some very vocal advocates of this view (e.g. Professor Giersch, president of the Kiel Institute of World Economics) emphasize in particular the contrast between the high flexibility and technological lead of the American economy versus the rigidity and alleged technological lagging behind of the European economies (what they call "Eurosclerosis"). In their view, this difference between the United States and Europe will keep the dollar high irrespective of interest rate movements or current account deficits. This view is often called the "portfolio theory" of the dollar. Mr. McNamar, former Deputy Secretary of the U.S. Treasury, recently defined this portfolio theory as follows: [3] "Exchange rate movements are a function of investment preferences at a country level . . . I believe the dollar's strength reflects, not some temporary interest rate or trade balance factor, but a fundamental relative improvement in U.S. economic policies, performance and prospects compared to the other reserve countries.".

Which of these mutually exclusive opinions is right: the optimistic or the pessimistic one? In my view both are misleading, because both take partial aspects as an explanation for the whole. This shows up clearly when we look more closely at the actual composition and development of the American capital balance (cf. table).

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[3] At the Davos Symposium, Davos, Switzerland, February 2, 1985.

CAPITAL BALANCE OF THE UNITED STATES

[In billions of dollars]

	Foreign assets in the United States: capital inflows (net) = +			U.S. assets abroad: capital outflows (net) = −			Net movement: net capital inflow = +		
	1982	1983	1984 [p]	1982	1983	1984 [p]	1982	1983	1984 [p]
Official transactions: (U.S. and foreign)	3.3	5.3	3.0	−11.1	−6.2	−8.6	−7.8	−0.9	−5.6
Private transactions (total) [1]	124.8	85.7	119.8	−107.8	−43.3	−12.6	+16.9	+42.4	+107.2
Of which—									
Direct investment	14.9	11.3	21.2	+4.8	−4.9	−6.0	+19.6	+6.4	+15.2
U.S. Treasury securities	7.1	8.7	22.5				+7.1	+8.7	+22.5
Other securities (bonds and stocks)	6.4	8.6	13.0	−8.1	7.7	−4.8	−1.7	+0.9	+8.2
Claims (−) and liabilities (+) of U.S. banks	65.9	49.1	27.6	−111.1	−25.4	−7.3	−45.1	+23.7	+20.3
U.S. non-banks (corporations etc.)	−2.4	−1.3	[2] (5.5)	+6.6	−5.3	[2] (+5.6)	+4.2	−6.6	[2] (+11.1)
Unrecorded inflows (net)	32.9	9.3	[3] (30.0)				+32.9	+9.3	[3] (+30.0)
Balance on current account							−9.2	−41.6	−101.6

[1] Incl. unrecorded inflows (net) = "statistical discrepancy".

[2] Claims and liabilities of US non-banks were available only for the first three quarters of 1984.

[3] Unrecorded capital flows include the net foreign borrowing of US corporations in the fourth quarter of 1984 (they are not yet available).

First, by far the largest change between 1982 and 1984 was the decline in foreign lending by American banks, namely from $111 billicn in 1982 to nearly zero in 1984. This would by itself explain the net improvement of the American capital balance over this period! Even if we take this enormous change on the credit side of the American banks together with the changes in their liabilities to foreigners, the turnaround of the American banks from being net lenders to net borrowers from abroad is still by far the largest change in the capital balance between 1982 and 1984. Apart from the effect of the international debt crisis on bank lending, there have also been other constraints on foreign lending by American banks, and probably a lower demand for dollar credit on the part of other industrial countries. Where does this leave the portfolio theory, which tries to explain everything by the decisions and preferences of foreign investors?

Second, among the recorded capital inflows, a growing part has been due to borrowing abroad by American corporations, mostly at medium term in the Europmarkets.[4] For the foreign lenders, it certainly could be counted among dollar portfolio movements. But the initiative has been on the American side, and these transactions were certainly not carried out irrespective of the interest rate differentials.

Third, for those who plead that the overriding attraction has been the dynamism and the higher earning power of American business, the statistics hold a disappointment in store. For this high earning power should chiefly be reflected in foreign purchases of American stock and foreign direct investment in the United States. Both items together contributed, however, relatively little to the financing of the enormous increase in the American current account deficit. They constituted in 1984 no more than about one fourth of the total recorded inflows of private capital. After all, since the middle of 1983 the Ameircan stock exchange has performed less well than the Japanese and some European stock exchanges.

Fourth, a look at the geographical sources of capital flows to the United States strongly confirms that the better economic performance of the United States is only one among several factors, and not even the most important one. Contrary to a generally held opinion, it is not mainly Europe from which capital is being pulled to the United States. This capital is coming from all over the world, and the main supplier has recently been Japan—which after all, is not suffering from "Eurosclerosis"! Just compare the following figures: in 1984 West Germany, the largest European exporter of capital (on a net basis), experienced a net long-term capital outflow to the United States of about 2½ billion dollars, to which a few billion dollars of short-term flows have to be added.[5] This is a small contribution to the total identifiable private capital inflow into the United States during that period. On the other hand, Japan had during 1984 a stupendous net long-term capital outflow of no less than $49 billion of which, according to Mr. Ogata, deputy governor of the Bank of Japan, $29 billion was Japanese investment in foreign securities, mostly dollar bonds, while foreign borrowing in Japan amounted to $14 billion. There can be no doubt that a major motivation for these huge capital flows was the difference between the high American and the much lower Japanese interest rates—buttressed by an underlying confidence that the dollar, if a turnaround were to come, would fall only moderately.

Summing up some major characteristics of the American capital balance over the three years 1982 to 1984:

It is evident that the huge increase in net capital inflows is a multi-variant phenomenon which cannot be satisfactorily explained by one single factor.

A major part of the increase in the net capital inflow has been due to initiatives on the American side, as evidenced by the sharp drop in foreign lending by American banks, by the increased borrowing abroad of American corporations, and by actions of the American administration which have facilitated the inflow of capital.

High American interest rates have clearly played a big role, while other contributions have come from confidence considerations (including the "safe-haven" motive) as well as from attractive after-tax earnings prospects in the American economy (without which the high nominal interest rates could not have been sustained for so long). I would say: the crucial factors as concerns foreign investors have been interest rates and confidence, and often a combination of the two.

There is no denying the fact that there exists a sharp contrast between America and Europe as concerns economic and financial flexibility, wage and other rigidities, etc. But this difference seems at present to be largely compensated for by the distorted exchange rates: witness the unusually high profitability of many European export-oriented industries, a phenomenon which is equally apparent in Japan.

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[4] For the above table on the U.S. capital balance the future for the borrowing abroad by non-banks was not yet available for the fourth quarter 1984. It is assumed to have been considerable. In the table it is contained in the "statistical discrepancy" or "non-recorded inflows".

[5] The regional breakdown of German short-term capital exports is not yet available.

As a general impression from an analysis of the American capital balance, I would conclude that some of these movements, and in particular the retrenchment of American bank lending abroad, are unlikely to continue indefinitely in similar magnitudes. The increasing net dollar-asset position in the world may also lead to a certain saturation point in the global addiction to the dollar.

IV. THE ROLE OF INTEREST RATES

At any rate, even in the opinion of adherents of the classical portfolio theory, "relative changes in interest rate differentials are clearly one element influencing exchange markets", although "they cannot explain the dollar's persistent strength" (McNamar).[6] It is a moot point whether one has to look primarily towards nominal interest rate differentials or whether real interest rate differentials are the decisive influence on interest-rate-oriented capital flows. In my view, the major factor in this field are nominal differences in interest rates together with exchange rate expectations and possible tax advantages. But even if "anticipated relative after-tax real rates of return" are chosen as the decisive influence,[7] movements in nominal interest rates play a role, if all other things (relative inflation and taxes) remain equal.

The significant decline of American interest rates in the second half of 1984 and the simultaneous increase in the dollar have sometimes been quoted as conclusive proof against the connection between interest rate differentials and the dollar.[8]

First, interest rates in Germany and Japan had not followed the upward surge of American interest rates during the first half of 1984, but had "uncoupled" themselves. At the end of 1984 at least their medium and long-term rates were considerably lower than at the end of 1983, and the difference from corresponding American interest rates was not smaller but actually higher than at the end of 1983; measured by the yield on long-term government bonds in America and West Germany it was 4.5 per cent at the end of 1984 against 3.6 per cent at the end of 1983 (it was different for short-term rates).

Second, at the beginning of 1985 the interest advantage for dollar assets over Yen and Dmark assets was still between 3 and 4 percentage points. This would be enough to set a wholesale exodus capital to the United States in March, at least from those countries which enjoy freedom of capital movements, were it not for the exchange rate risk. As is well known, the exchange rate risk for the dollar against the Dmark and the Yen was rated much lower at the beginning of 1985 than at the beginning or in the middle of 1984. Thus, one has always to look at interest rate differentials combined with the anticipated exchange risk. This can, of course, lead to a self-fulfilling prophecy (or a bootstrap phenomenon): a more favourable anticipation of future dollar rates can make an existing interest rate differential more attractive more and lead to higher capital inflows, thus confirming the more favourable forecast.

Third, in 1984 there were some other important developments which boosted capital flows into the dollar, even at lower interest rate differentials. One factor was the liberalisation and internationalisation of the Japanese financial markets. The American-Japanese agreement of May 1984 seems to have contributed, at least in its initial stage, mainly to the opening of the Japanese capital market to foreign borrowers and to a considerable upsurage of capital exports from Japan to the United States. Thus, it clearly boosted the dollar and depressed the Yen exchange rate, very much against its intended purpose. Another factor was the abolition of the American withholding tax on interest earned by foreigners. This has made foreign investment in American securities more attractive, even at a lower interest rate difference. A tax-free 10 per cent yield may be more attractive than a taxable 12 per cent yield.

It is obvious that interest rate differentials alone cannot explain every movement of the dollar, particularly over shorter periods. But this is even more true of the portfolio theory or the more dogmatic view of the unmitigated dollar optimists. Both do not take account of the major role played by the drastic change in the external position of the American banks and only partly of the increased foreign borrowing by American corporations. And what has really changed since mid-1984 in the after-tax real rate of return in favour of dollar assets? Have the earnings prospects of

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[6] R. T. McNamar, Deputy Secretary of the Treasury, speech before the National Foreign Trade Council, New York, January 30, 1985, page 8.

[7] See McNamar, l.c. page 8.

[8] See McNamar, l.c. page 7.

American business significantly improved since then relative to Japan or Europe? If anything, it has been the reverse. The modest capital inflows in the form of direct investment and foreign purchases of American stocks seem to confirm this.

But when all is said it is still true that interest rate differentials in favour of dollar assets, especially if they are combined with optimistic exchange rate expectations, can have a significant influence on capital flows and the exchange rate of the dollar. This raises some fundamental questions. Is the present interest rate differential in favour of dollar assets a true indicator of underlying differences in long-term profitability? Is it true, as some American experts claim, that it helps to steer the world's savings to the most productive uses? Here some doubts are in place. For the historically high American interest rates are mainly due to government policies and interferences. One such factor is the high structural budget deficit. Is it a productive use of foreign capital if it helps finance—directly or indirectly—such a structural budget deficit? Another distortion results from the American tax system, and here both from the general tax deductibility of interest payments as well as from the over-generous tax advantages for new investment which have been so much enlarged by the 1981 and 1982 tax acts.[9] This has created a relative insensitivity of business, housebuilding and consumers to high interest rates, which has inevitably held the equilibrium level of interest rates high. This helps to explain the strength of investment in the face of very high real interest rates (for which some other reasons may be found, too). At any rate, the change of the United States from a former low-interest country to the structural high-interest country of today is to some extent an artificial phenomenon, and is not entirely due to a significantly higher pre-tax profit potential. The conclusion that the present tax advantages for American business are artificially high is underlined by the fact that the recent Treasury proposals for a "fairer" tax system envisaged a partial elimination of these tax features. But the fact remains that interest rate differentials and international financial flows are at present strongly influenced by international tax differentials, especially with regard to business investment. Should we embark on an international competition with regard to tax systems? Perhaps. . . .

Another fundamental question has been raised with regard to the role of free capital movements in such a distorted scenario. The misalignment of the dollar has provoked very dangerous protectionist pressures. Some have asked: Would it not be better to put some restraint on these unbalancing capital flows and thus help to preserve free trade in goods? An interest-equalization tax (on the model of the U.S. tax of 1964) or outright capital export controls have been suggested. The West German and British authorities have immediately rejected such ideas. The Japanese have—inadvertently!—even opened the door wider for capital outflows, thus involuntarily depressing the Yen against the dollar and increasing the dangerous trade and payments imbalance.

A more rational reaction to the existing international imbalance would, of course, be an attempt to come to grips with the underlying causes of the acute capital shortage in the United States and the large interest rate differentials. Needless to say that this would presuppose a change in the American policy mix toward a less expansive budgetary policy, and also a revision of the American tax system which is keeping the equilibrium interest rate artificially high.

The experience of the last two years has convincingly demonstrated that it is not enough that the leading countries pursue "sound non-inflationary policies" in order to attain a stable and well-balanced system of exchange rates. Such a convergence towards non-inflationary policies was actually reached in 1983 between the United States, Japan and West Germany. But nonetheless the disturbing misalignment of the dollar against these other currencies has even significantly increased. The convergence toward non-inflationary policies must also be supported by a sound relationship in the fiscal-monetary policy mixes and in interest rates. Only in this way can we hope to achieve a more rational and also more stable exchange rate structure.

There are at present great contrasts in budgetary policies between America on the one side, Japan and a number of European countries on the other side. There are also large differences between them as concerns the impact of taxation on the equilibrium interest rate level. It has sometimes been suggested to promote a better balance by deliberately relaxing fiscal and tightening monetary policies in some European countries. But that would mean absorbing even more capital resources for budget deficits and making capital even more scarce worldwide.

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[9] According to a study by a Washington institute, the average tax rate on business profits from new investment has plummented from 33 percent in 1980 to 4.7 percent in 1984. A report of a Congressional Committee of December 1984 mentions that tax payments of nonfinancial corporations accounted in 1980 for 12.5 percent of total tax income, in 1983 for only 6.2 percent (according to a newspaper report).

There can be no doubt that the main responsibility for getting out of the uncomfortable exchange rate trap lies with American fiscal policy. After all, the United States is at present clearly living beyond its means and is "becoming addicted to a large flow of capital from abroad" (Paul Volcker)—with the danger of heavy withdrawal pains should this capital inflow diminish abruptly. Moreover, this continuous piling up of external debt represents a heavy mortgage on the future.

Of course, some European countries could also make a contribution by strengthening the profitability of business investment and thus making it less sensitive against relatively high interest rates. This might lead to a smaller outflow of capital to the United States and to a support for European currencies. Would this mean following President Reagan's recent advice that the other industrial countries should "catch up with the U.S. recovery" in order to get more balanced exchange rates? Not entirely. For he probably wanted to suggest (like other high American officials) that Europeans should pursue a more expansionary budget policy. This might, however, be counter-productive. The only sensible contribution on the European side would, in my view, be a better climate and better conditions for business investment, including a more flexible wage and labor system.

At least up to March 1985, the American capital gap was overfinanced by the large net inflow of foreign capital (together with the virtual stop of American lending abroad). This overfinancing is reflected in the constant upward pressure on the dollar. Thus, from the point of view of the external equilibrium the present American interest rates are too high. In some recent remarks,[10] Paul Volcker seemed to imply that one could not risk any relaxation because of the need to attract sufficient foreign capital. This would not, however, justify maintaining interest rates at a level where excessive capital inflows keep the dollar excessively high. The external current account deficit is more or less identical the domestic capital gap. Finding the right level of interest rates, consonant with the real need for foreign capital inflows and without endangering the domestic equilibrium, is certainly a high-wire act. But at a time when the exaggerated surge of the dollar constitutes a major risk for the American economy—including the risk of being pushed into irreversible protectionist mistakes—monetary policy should perhaps look more than before also towards the exchange rate as an indicator.

V. FUTURE PROSPECTS

What about future prospects for the dollar? It is fairly safe to predict that the overly high dollar will one day have overreached itself and will produce its own downfall by its exaggerated effects. But it is impossible to predict *when* the turnaround will come—it is an inexorable, but unpredictable future event. If we want to get some idea about what lies immediately ahead, we would have to make assumptions concerning budgetary policy, economic activity, inflation performance and interest rates in the United States in 1985 and 1986. I want rather to concentrate on interest rates, as one of several elements of the future scenario, in which the other elements may be reflected. Is it worthwhile to speculate on the likely development of American interest rates? Forecasts for them since the middle of 1984 have been wrong at least as often as forecasts for the dollar. I will nevertheless risk a forecast by repeating one which I made in a speech in Washington in September 1984, shortly before the recent general downward movement of American interest rates began. I think that between now and the end of 1985, American interest rates are more likely to go further down than up (with the usual short-term fluctuations up and down) unless the American economy, against all the odds, were to bounce back strongly in 1985.

Why are they likely to decline? First, because of the softening in the American economy. Second, because American wage costs and prices are likely to rise only moderately, in future too, and far less than previously expected. Third, because I count on the psychological effect of likely budget-cutting measures for 1986 and beyond—not the least important reason!

Interest rates in other countries are likely to follow suit, but probably only in part, so that the interest rate differential may shrink. But a slight reduction in present differentials does not necessarily portend an immediate, abrupt fall in the dollar. We should not forget that interest rates are not the only relevant factor, but that taxation, evaluation of exchange risk and general confidence factors all play their part in foreign investment. If American interest rates go down in connection with a convincing cut in the budget deficit, this may increase foreign confidence in the United States so much that the dollar may remain strong despite lower interest rate spreads. But a significant budget cut would probably also slow down the American economy—at least temporarily—and reduce business profits. Thus, the dollar may decline not only because of lower interest rates but also because the American profit situation will no longer look as attractive as before. This would be even more likely if the proposed tax reform were to reduce some of the over-generous tax benefits for American corporations.

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[10] Before the domestic monetary policy subcommittee of the House Banking Committee, February 26, 1985.

VI. SOFT LANDING OR ABRUPT FALL OF THE DOLLAR

If we think about the coming turnaround of the dollar we encounter another problem. If—or when—sooner or later a readjustment of the dollar to a more normal level comes, will it be through a "soft landing," i.e. a gentle decline, or through a precipitous fall, with inevitable overshooting?

The outcome is very important both for the U.S. economy and for the rest of the world. As Paul Volcker once said: a dollar collapse triggered by a loss of foreign confidence would open a Pandora's box of economic problems for the United States. It could drive up the inflation rate and might possibly upset my optimistic forecast about American interest rates. On the other hand, it would help the American economy to get out of its foreign trade impasse, although it would probably take quite some time before the American trade and current account balance showed a significantly better picture.

For the rest of the world, an overly abrupt fall in the dollar would upset a lot of trade and competitive relationships. As a counterpart it would give other industrial countries a greater leeway for monetary policy, and it would lessen protectionist dangers. For the highly-indebted Third World countries, the net outcome would mainly depend on the impact on dollar interest rates, dollar commodity prices, and on U.S. economic activity.

I would say: in the short run, an abrupt and exaggerated fall in the dollar would involve more difficulties and problems than advantages. Therefore, I do not subscribe to the view that the best news for the world economy would be a lower dollar. It very much depends on the way in which it were to come about. To paraphrase a famous saying of St. Augustin: "O Lord, give us a lower dollar, but not too soon or too abruptly!" What are the prospects for a "soft landing"? It has rightly been said (among others by Mr. Leutwiler, former president of the Swiss National Bank and former Chairman of the BIS) that the longer the distorted dollar value and the huge one-sided capital flows last, the larger the potential for an exaggerated fall becomes. But there are also some reasons for expecting a "soft landing": there is first an unexpectedly low inflation rate in the United States and the international confidence in the American central bank. Secondly, since other countries will be greatly interested, too, in "softening" an eventual dollar adjustment, they would probably help by lowering their own interest rates (which they could do without any great risk if and when a dollar fall provides them with lower import prices and lower pressure of export demand). Thirdly, there is still the possibility that the U.S. Congress will finally agree on a confidence-inspiring cut in the budget deficit for 1986 and beyond. If the "addiction to foreign capital" (Volcker) were thus lessened, the adjustment of the dollar would certainly proceed more smoothly.

We have repeatedly heard from American government officials that "the U.S. has no plan aimed at coping with a possible steep plunge in the dollar's value" (Mr. Donald Regan). But plan or no plan, indirectly it is, of course, largely American fiscal and monetary policies which will be decisive when the turnaround comes.

How far could intervention in the exchange markets contribute to an orderly retreat if and when the turnaround comes? This is a controversial subject, particularly in America. I believe that intervention, especially if it is a concerted action on both sides of the Atlantic, could soften the movement and smooth out erratic exaggerations. But intervention in the exchange markets is certainly a secondary matter compared with appropriate fiscal and monetary policies. Nevertheless it might have been useful if American authorities had accumulated some foreign exchange reserves in time, so as to be prepared for future contingencies (and this may be profitable, too). Just a side-remark: it is utterly misleading to refer to the huge volume of transactions in the foreign exchange markets—a daily volume of up to $100 billion has been indicated for the New York market alone—in order to make central bank interventions of $1 to $2 billion look ridiculous. What is essential for comparison is not the gross volume of inter-bank trading, but the net amount of purchases or sales of dollars in the market. Speculators who are at the same time hedging their positions have no lasting influence. Although these net amounts can also rise to several billion dollars a day, there are situations of overbought or oversold currencies where even a few hundred million dollars can have a significant smoothing effect.

VII. THE HIGH DOLLAR—INCREASINGLY AN AMERICAN PROBLEM

Which side has suffered most from the excessive dollar value? In my view, the longer this imbalance lasts, the more it will be the American economy which suffers most:

Through the distortion of its competitive position in the world and the consequent distortions in its whole economic structure which have led to a split-level economy;[11]

Through the accumulation of an enormous external debt which will not only make the United States a net debtor country but whose increasing interest burden will weigh on the American current account for a long time ahead;

And because of the drag it exercises on current economic activity in the United States. It is strange that Americans are only now beginning to realize that, by depressing profits in large sectors of the economy and deflecting a lot of demand abroad, the high dollar in conjunction with the huge trade deficit has not only contributed to the present softening in the American economy but has also compromised future growth prospects by lowering investment in a significant part of industry.

To be sure, the high dollar has also involved advantages: it has in 1983/84 helped to prevent an overheating in America through deflecting demand abroad, it has kept the inflation rate down in America, and it has given an impetus to rationalize and to increase productivity. It is also true that the large net inflow of foreign capital has alleviated the pressure which the financing of the budget deficit would otherwise have exercised on the domestic financial markets and thus has prevented a still higher interest rate level and a crowding out of private investment. Prof. Feldstein once wrote: as long as we have the high budget deficit, it is more of an advantage than disadvantage to have large capital inflows, a high trade deficit, and a high dollar. But over time—and with the increasing misalignment of the dollar—the balance has now clearly shifted to the disadvantage of the American economy.

It is nearly the reverse for the rest of the world: in the past, one could complain that the high dollar and the high American interest rates behind it, forced overly high interest rates on the rest of the world and thus retarded its economic recovery. But this no longer holds entirely true. In countries with good domestic stability, like Japan, West Germany and some others, monetary policy and interest rates have been largely (although not entirely) uncoupled from the high dollar since about the beginning of 1984. The price-raising effect of the high dollar on import prices has partly been offset by the fall in the dollar prices of commodities (incl. oil), and partly by lower domestic cost increases (so that in Germany and Japan the domestic inflation rate could be kept around 2½ per cent).

Much more important are the benefits, and in particular the stimulus which the combination of the American domestic expansion together with the strong dollar has exerted on the European economies. It is not only reflected in the strong increase of European exports to North America (by over 30 per cent in dollar terms in 1984), but equally in the indirect effects of the American expansion on important European markets, including the LDCs. This external stimulus came just at the right time, namely when domestic demand in Europe was languishing,[12] partly because of restrictive fiscal policies, partly for other reasons. An expansionary stimulus which did not increase indebtedness was what Europe needed in 1983/84, also in order to be able to carry through the budgetary improvements so badly needed for structural reasons.

Thus, for a number of industrial countries the benefits to their exports, and to their whole economic activity, arising from the strong American expansion and the high dollar have clearly outweighed the negative influence on their monetary policies. Japan and a number of European countries have learned to live with a strong dollar. Even France has been able to enjoy a continuous lowering of its interest rates over the last few months.[13] If Britain in January 1985 had the opposite experience, it was only partly attributable to the high dollar and more to a combination of several specific British problems. Finally, the strong dollar, by keeping the Dmark down, has contributed to the longest period of exchange rate stability in the European Monetary System since it was set up in 1979.

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[11] This distortion is not diminished by the fact that perhaps less than one half of the overall deterioration of the American trade balance can be attributed to the strong dollar.

[12] Domestic demand in real terms increased in Western Europe by only 1 per cent in 1983 and 2 per cent in 1984, as compared to 4.6 per cent and 8¾ per cent in the United States.

[13] Raymond Barre, the former French prime minister, recently even praised the high dollar.

This rather positive evaluation of the effects of the high dollar on Europe should, however, not let us overlook some possible *future* costs and risks. Should, for instance, the dollar rise significantly higher than it was in February 1985, then a breaking point may be reached where the disturbing effects on European prices and monetary policies, but also a likely negative reaction of American trade policy, might more than outweigh the advantages. Another risk is a too abrupt fall of the dollar, the possible effects of which I have briefly described above. But even if there should be a "soft landing" of the dollar, we cannot neglect the costs, both in America and in Europe, of misguided investment planning as a consequence of the distorted dollar value. The overly strong dollar has been giving misleading signals to industries on both sides.

Thus the strength of the dollar has been no unmixed blessing for Europe. The main drawback and risk is that—sooner or later—a turnaround seems to be inevitable. But for Europe it is more a future risk, while for America it is a present burden. And the burden is growing stronger, the longer the distortion lasts. Some time ago, a well-known American magazine carried the headline: "The dollar, a source of pride and problems". Over time the problems will gain the upper hand. Sooner or later people may become aware of the fact that the huge external deficit and the distorted exchange rate of the dollar are very acute problems for the American economy. They are, at least in part, connected with the excessive budget deficit. Maybe the pressures arising from the huge external imbalance and its consequences will help to get the domestic imbalance under control.

I remember that about a dozen years ago a high U.S. official said to the Europeans: "The dollar is our currency, but your problem!" I have the impression that now the dollar has returned home as a problem of the United States. This is particularly true if we not only consider the present problems, but also look ahead to the sombre eventualities of the future.

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